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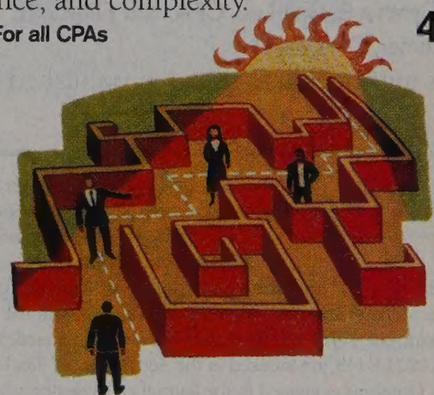

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JOURNAL OF ACCOUNTANCY

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Jeff Drew is a *JofA* senior editor. He oversees coverage of practice management and technology. He has more than 20 years of journalism experience, including a decade in various editorial capacities with American City Business Journals.

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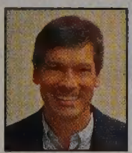

Ken Tysiac is a *JofA* senior editor. He covers breaking news for journalofaccountancy.com and for print. He has more than 20 years of journalism experience, including work with *The Charlotte Observer* and *The News & Observer* of Raleigh, N.C., and has had two books published.

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Sabine Vollmer is a *JofA* senior editor and oversees coverage of international accounting issues. She also curates the *Global CPA Report* and writes news for *CGMA Magazine*. She has more than 20 years of journalism experience, including more than 10 years as a business writer. She has also worked in Germany and Japan.

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Joel Sinkin is president of Transition Advisors LLC in New York City. The firm exclusively consults on ownership transition for public accounting firms, providing advice on succession planning, mergers and acquisitions, and partnership agreement issues. He has been involved with and consulted on hundreds of successful closings of accounting firm mergers and acquisitions over the past 20 years, has taught CPE courses for state and national accounting associations around the country, and has published books and articles nationally. He also is an editorial adviser to the AICPA newsletter *Small Firm Solutions*.

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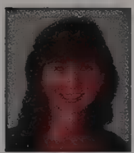

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FASB Changes Leadership, Not Direction

Russell Golden

New board chairman to focus on convergence projects and private companies.

by Ken Tysiac

Russell Golden, whose technical expertise as a FASB staff member led him to a spot on the standard-setting board in 2010, was scheduled to succeed Leslie Seidman as FASB's chairman on July 1.

Golden said the board's immediate priorities include completing international convergence projects and ensuring that accounting standards for private companies are relevant. Upon being named as the next chairman, he discussed several important issues during a conference call with reporters.

Here are some of his comments:

On priorities: "The initial priorities will be the completion of the four MoU [memorandum of understanding] projects [and] focusing on improving accounting for private companies. There will also be ... a survey [conducted in May] that will be produced by the Financial Accounting Standards Advisory Council, or FASAC, which is an important survey to gather information about potential agenda items for the FASB. So following the results of that survey, I would want to consult with stakeholders, consult with senior staff, and consult with members of the board to develop the priorities following the completion of the MoU projects."

On the new Private Company Council (PCC): "I believe the PCC is off and running and has been doing an absolutely fantastic job. The members of the PCC and the chairman [Billy Atkinson] are extremely committed to working through, with the board, improvements to private company accounting standards, and I believe that will be a great step forward to produce more relevant and more cost-efficient standards for the private company community."

On the disclosure framework project, which aims to have financial statements reflect only relevant information and reduce clutter: "I think the disclosure framework is a very important project to both improve transparency to investors and to reduce the cost to investors as well as to preparers. I'm very pleased the project is moving along, and I hope to treat that with my fellow board members as a priority to finish in the coming months an exposure document."

On future work with the International Accounting Standards Board (IASB): "We've been working quite extensively recently on the four MoU projects, which are *Accounting for Financial Instruments—Classification and Measurement*, *Accounting for Financial Instruments—[Credit] Impairment*; *Revenue Recognition*; *Leases*; and *Insurance*.

"We are close to issuing a very important, converged solution on revenue recognition, which I have been working on for a number of years and I believe will be a good success, and will improve financial reporting for companies across the world.

"[After] the MoU projects, the primary way in which we will continue to work with the IASB is providing advice as part of the Accounting Standards Advisory Forum, [and] working with them on the implementation efforts of ... these very important, large projects, with the goal that we can educate our constituents, we can help them make the interpretation, and, most importantly, we can continue to sustain a converged conclusion."

On the chances for a converged solution on the* Accounting for Financial Instruments—Credit Impairment *project: "As you know, that project is out for proposal, and we, jointly with the IASB, plan to hold a number of field visits, a number of other workshops and tools to gain input from our stakeholders across the globe, and I'm committed to working through these issues to arrive at a converged, improved solution." ❖

Ken Tysiac is a JofA *senior editor. To comment on this article or to suggest an idea for another article, contact him at ktysiac@aicpa.org or 919-402-2112.*

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News Digest

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HIGHLIGHTS

The Private Company Council (PCC) made progress toward creating the first GAAP exceptions and modifications for private companies.

PCC members voted to issue an exposure draft seeking public comment on proposed alternatives to GAAP designed to improve financial reporting for private companies. A simple majority of FASB members must endorse the ED before the proposal is issued for public comment.

The PCC tentatively decided to:

- Relieve private companies from separately recognizing certain intangible assets acquired in a business combination.
- Allow private companies to amortize goodwill and use a simplified goodwill impairment model.
- Allow two simpler approaches to accounting for certain types of interest rate swaps when a private company intends to economically convert the interest rate on its debt.

"The PCC took action on issues of critical importance to private companies, representing an important milestone in our joint efforts with the FASB to improve financial reporting in the areas of intangible assets, goodwill, and interest rate swaps," PCC Chairman Billy Atkinson said in a news release. "The robust discussion and collaboration between the PCC and the FASB made this first step toward improvement possible."

Formed last year by the Financial Accounting Foundation, FASB's parent organization, the PCC has been charged with voting on GAAP exceptions for private companies.

Following the public comment period, the PCC will redeliberate the proposed exceptions and modifications and forward them to FASB. If FASB gives its final endorsement, the alternatives for private companies will be incorporated into GAAP.

AUDITING

The European Union took a step toward requiring mandatory audit firm rotation when the European Parliament's Legal Affairs Committee voted 15–10 in favor of a draft law that would require public-interest entities such as banks, insurance firms, and listed companies to rotate audit firms every 14 years.

That period could be extended to 25 years when certain safeguards are put into place.

The vote resulted in a toned-down version of reforms previously proposed by the European Commission, which called for mandatory rotation every six years. A majority on the Legal Affairs Committee judged that period to be a costly and unwelcome intervention in the audit market, according to a committee news release.

The proposal still has to go through several steps before it becomes law, beginning with negotiations with the European Council. Sajjad Karim, a European Parliament member from the United Kingdom who drafted the reforms, said during a news conference that he hopes a final vote in Parliament will take place before the end of the year.

The full story on the proposal is available at tinyurl.com/bsbhs6q.

The PCAOB reproposed an auditing standard and amendments designed to improve the quality of auditing of related-party transactions and significant unusual transactions.

The reproposed standard is designed to increase the auditor's focus on the evaluation of how a company identifies, accounts for, and discloses its relationships and transactions with related parties.

The reproposed amendments, meanwhile, are intended to help the auditor identify and evaluate a company's significant unusual transactions. In addition, the reproposed amendments would require the auditor to perform new procedures as part of the process to assess the risk of material misstatement in financial statements.

These procedures would give the auditor an understanding of a company's financial relationships and transactions with executive officers, the PCAOB said. But the auditor would not be required to make any determination or recommendation regarding how reasonable the compensation arrangements are.

Commenters generally supported the previous proposal, which the PCAOB released on Feb. 28, 2012, according to PCAOB Deputy Chief Auditor Greg Scates. But commenters also offered suggestions for improvements and adjustments, which are included in the new proposal, Scates said.

Several changes in the new proposal, available at tinyurl.com/bqz5sof, include:

- Clarifying the relationship of the proposal with the PCAOB's existing risk assessment standards.
- A requirement to evaluate whether the company has properly identified its related parties and its relationships and transactions with related parties.
- Removing the requirement that each related-party transaction previously undisclosed to the auditor by

management be treated as a significant risk.

The PCAOB's existing standard, AU Section 334, *Related Parties*, would be superseded by the reproposed standard. The reproposed amendments would amend other auditing standards, including AU Section 316, *Consideration of Fraud in a Financial Statement Audit*, and Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement*.

Comments are due July 8.

■ The AICPA Auditing Standards Board (ASB) has exposed a new, clarified standard that applies to use of the work of internal auditors.

With the issuance of the Proposed Statement on Auditing Standards (SAS), *Using the Work of Internal Auditors*, the ASB has completed the clarity project redrafting of its last unclarified AU section in the AICPA *Professional Standards*.

The proposed SAS would supersede AU Section 322 and AU-C Section 610, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements*.

Amendments include significant changes to AU-C Section 315, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*. An explanatory memorandum describing the most significant changes to the SAS is provided in the exposure draft.

The proposal is available at tinyurl.com/csokk9u. Comments are sought by July 15 and should be addressed to Sherry Hazel at shazel@aicpa.org.

Readers are specifically asked:

- To respond to the proposed requirements and application guidance relating to using internal auditors in a direct assistance capacity.
- Whether the changes from the requirements and guidance included in International Standard on Auditing No. 610 (Revised 2013), *Using the Work of Internal Auditors*, are appropriate.

■ Independent auditors sometimes find themselves in conflict with regulator-prescribed forms.

In an emerging issue for auditors, some of them have found that the reports they are required to submit to state regulators do not contain the specific elements and wording of generally accepted auditing standards (GAAS) that state accountancy laws require auditors to follow.

The AICPA's website is providing resources (visit tinyurl.com/cku4efx) to help auditors find solutions to this issue. Many state regulators require that auditors provide an opinion on financial information to a regulator, often by means of an auditor's report on forms prescribed by the regulator.

If the minimum required reporting elements and wording are not contained in the prescribed form, the auditor is required by GAAS to reword the prescribed form of the report or attach an appropriately worded separate report.

This issue first surfaced in New York with a form required by the New York City Tax Commission. The technical teams of the New York State Society of CPAs and the AICPA crafted a solution that allows auditors to meet the AICPA Auditing Standards Board's new standards without requiring the city of New York to issue a new form.

This was accomplished when the commission agreed to accept either footnotes to the city's form or a separate report attached to the form. Members who encounter this problem are encouraged to contact the AICPA or their state societies for assistance.

Contact Ahava Goldman, AICPA senior technical manager (agoldman@aicpa.org or 212-596-6056), with questions.

■ Recently implemented federal rules on disclosure of conflict minerals have mandated new audit requirements for some U.S. issuers.

The AICPA Conflict Minerals Resources webpage (tinyurl.com/cdgwk9p) provides background and other useful information about the use of conflict minerals, which are gold, tantalum, tin, and tungsten.

In addition, new Questions and Answers (available at tinyurl.com/c8n9plt) have been issued to provide nonauthoritative guidance and describe the key similarities and differences between the two services—an examination attestation engagement and a performance audit—that can fulfill the SEC's mandate of an independent audit of the conflict minerals report.

The mandated conflict minerals disclosure rules are among the provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act, P.L. 111-203. The SEC's final rule, adopted in August 2012, requires issuers who use those minerals in their manufacturing processes and supply chain—and have determined that those minerals originated in the Democratic Republic of the Congo or its neighboring countries—to file a Conflict Minerals Report with the SEC and publish the report on the issuer's website.

The report must be independently audited in accordance with U.S. *Government Auditing Standards* (The Yellow Book) and can consist of either an examination attestation engagement or a performance audit.

■ A new Statement of Position (SOP) released under the authority of the ASB establishes guidance for attest engagements on entities' greenhouse gas emissions statements.

SOP 13-1, *Attest Engagements on Greenhouse Gas Emissions Information*, supersedes SOP 03-02, which had the same title. The SOP guides practitioners performing an examination or a review of a greenhouse gas emissions statement containing either a schedule with the subject matter or an assertion relating to information about an entity's greenhouse gas emissions.

The SOP also provides guidance on the application of AT Section 101, *Attest Engagements*, to greenhouse gas emissions attest engagements. SOP 13-1, available at tinyurl.com/cyy3t7a, takes effect for reports on greenhouse gas emissions information issued on or after Sept. 15. Early implementation is permitted.

FINANCIAL REPORTING

■ Stakeholders have expressed concerns to FASB that certain disclosure requirements for nonpublic employee benefit plans would reveal sensitive proprietary information of private companies.

FASB is addressing that concern by proposing an indefinite deferral of the effective date for certain disclosures about invest-

ments held by a nonpublic employee benefit plan in the plan sponsor's own equity securities.

Comments were due May 31 on Proposed Accounting Standards Update (ASU), *Fair Value Measurement (Topic 820): Deferral of the Effective Date of Certain Disclosures for Nonpublic Employee Benefit Plans in Update No. 2011-04*. The proposal is available at tinyurl.com/d7k8own.

Stakeholders have been concerned that proprietary information about private companies would be divulged through the dissemination of their employee benefit plans' financial statements on the plan regulator's website.

The deferral is proposed to allow time for regulators and stakeholders to discuss the specific quantitative disclosures and their potential effect on the plan sponsor as a result of making that information public. The proposed deferral would be effective when the final ASU is issued. At press time, the ASU was expected to be released in June.

■ A new FASB standard provides guidance for organizations on when and how to prepare financial statements using the liquidation basis of accounting.

ASU 2013-07, *Presentation of Financial Statements (Topic 205): Liquidation Basis of Accounting*, describes how financial statements must be prepared by a company that is converting its assets to cash or other assets, and is settling its obligations with creditors with the intent of ceasing its activities. The ASU is available at tinyurl.com/ckl8wpp.

In these circumstances, financial statements must be prepared using a basis of accounting that helps financial statement users understand how much the organization will have available to distribute to investors after disposing of its assets and settling its obligations.

Leslie Seidman, who was FASB's chairman when the standard was issued, said in a news release that the standard will reduce diversity in practice and addresses the concerns of stakeholders who had asked for guidance from FASB.

Organizations will be required under the new standard to use the liquidation basis for preparing financial statements when liquidation is "imminent."

When liquidation was specified in an organization's governing documents at inception (as in a limited-life entity), the liquidation basis should be used only if the liquidation plan differs from the original terms.

The standard applies to public and private companies as well as not-for-profit organizations. The ASU takes effect for interim and annual reporting periods beginning after Dec. 15, 2013, and early adoption is permitted.

■ GASB approved a new standard designed to help state and local governments report on nonexchange financial guarantees they have offered, and to help governments properly report on guarantees they have received on their obligations.

GASB Statement No. 70, *Accounting and Financial Reporting for Nonexchange Financial Guarantees*, spells out the provisions. A nonexchange financial guarantee is a credit enhancement or assurance a guarantor offers without receiving value in exchange that is equal or approximately equal.

The guarantor agrees to pay an obligation holder if the issuer of the obligation is unable to pay the obligation holder, as required. Examples of nonexchange financial guarantees include guarantees by a state for bonds issued by local governments within that state, and guarantees of mortgage loans to individuals, if equal or approximately equal value is not received in exchange.

A state or local government guarantor will be required to recognize a liability on its financial statement when it is more likely than not that the guarantor will be required to make a payment to the obligation holder under the agreement.

The standard took effect for reporting periods beginning after June 15, 2013, and is available at tinyurl.com/c47lpwq.

INTERNATIONAL

■ The International Accounting Standards Board (IASB) proposed an interim standard that would allow entities to preserve their existing accounting policies for rate-regulated activities—with some modifications to enhance comparability—while the board considers whether it should develop specific guidance.

Feedback from the IASB's agenda consultation led the board to launch a project to consider whether it should develop specific guidance for rate-regulated activities. The board also is trying to determine what information financial statement users would need about the consequences of rate regulation if specific guidance is developed.

Industry sectors such as transportation and utilities are subject to rate regulation in many jurisdictions, and rate regulation can significantly affect the timing and amount of an entity's revenue. But existing IFRS does not provide specific guidance for rate-regulated activities.

The exposure draft for the proposed interim standard, *Regulatory Deferral Accounts*, seeks comments by Sept. 4 and is available at tinyurl.com/bqrhrg3.

PERSONAL FINANCIAL PLANNING

■ Problems created by financial stress aren't limited to people's pocketbooks. A new survey found that money-related stress is also taking a toll on Americans' waistlines, friendships, and sleep habits.

The telephone survey, conducted March 14–17, asked 1,011 U.S. adults to name all the ways financial stress is affecting their lives. Of those who rate their financial stress "very" or "somewhat high," almost half, or 47%, said they are sleeping less. Another 43% said they have less patience with friends or are seeing them less often, while 31% are eating more junk food or gaining weight.

The survey also found that about one-fifth of respondents (21%) who rate their financial stress as at least "somewhat high" are arguing more with their spouse or significant other. And about one-sixth (17%) said they are getting sick more often, according to the survey results.

Harris Interactive conducted the survey for the AICPA in recognition of National Financial Capability Month, which is observed in April.

While the economy has improved since

the darkest days of the Great Recession, an increase in payroll taxes that kicked in at the start of the year intensified financial concerns for many Americans. The increase effectively cut take-home pay for most workers by 2% and prompted more than two-thirds (68%) of those employed to cut spending, reduce savings, or make other sacrifices, according to a news release about the survey that was issued by the AICPA.

PROFESSIONAL ISSUES

■ Baker Tilly Virchow Krause LLP, one of the 20 largest U.S. accounting firms, merged with Holtz Rubenstein Reminick LLP in a deal that gives Chicago-based Baker Tilly a significant foothold in New York City.

The merger closed June 1. It creates a firm with more than 1,600 professionals and $300 million in annual revenue, said Timothy L. Christen, CPA, chairman and CEO of Baker Tilly, in a news release. Holtz Rubenstein Reminick, with 145 professionals at offices in Manhattan and on Long Island, as of June 30, 2012, was ranked 24th on Crain's latest annual list of the largest New York accounting firms.

"We've been looking for the right merger partner in New York, and we found that partner in Holtz Rubenstein Reminick," said Christen, who will lead the combined firm. "They have a strong reputation, considerable technical excellence, and a record of success."

The combined firm is based in Chicago under the name Baker Tilly Virchow Krause LLP, and two Holtz Rubenstein Reminick representatives are joining the board. Holtz Rubenstein Reminick's managing partner, Barry Garfield, CPA, will head Baker Tilly's New York operations. Baker Tilly currently has a small New York office.

Baker Tilly is hoping to use its expanded New York base as a platform to help the firm expand further on the East Coast, specifically in the mid-Atlantic area between New York and Washington, where the firm has a significant presence. "With anchor offices in D.C. and New York, the merger will allow us to better serve existing clients and pursue strategic growth opportunities in the highly active corridor that connects our nation's capital with the largest commercial market in the United States," said Baker Tilly's executive managing partner, Ed Offterdinger, CPA, who will lead efforts to integrate the firms.

The deal is the latest in a series of mergers involving top 20 accounting firms (see accompanying chart).

DRAFTS OUTSTANDING

■ FASAB

Proposed Statement of Federal Financial Accounting Standards, *Reporting Entity*. Comment deadline: July 3. ED available at tinyurl.com/cx4qzrx.

■ FASB

Proposed Accounting Standards Update, *Technical Corrections and Improvements Related to Glossary Terms*. Comment deadline: Aug. 5. ED available at tinyurl.com/qxr7f2j.

Proposed Accounting Standards Update, *Presentation of Financial Statements (Topic 205): Reporting Discontinued Operations*. Comment deadline: Aug. 30. ED available at tinyurl.com/cmpwvbz.

Proposed Accounting Standards Update (Revised), *Leases (Topic 842)* (a revision of the 2010 proposed FASB Accounting Standards Update, *Leases (Topic 840)*). Comment deadline: Sept. 13. ED available at tinyurl.com/ldedjoo.

■ IFAC

Conceptual Framework for General Purpose Financial Reporting by Public Sector Entities: Presentation in General Purpose Financial Reports. Comment deadline: Aug. 15. ED available at tinyurl.com/bsumo9j.

■ ASB (AICPA)

Proposed Statement on Auditing Standards, *Using the Work of Internal Auditors*. Comment deadline: July 15. ED available at tinyurl.com/csokk9u.

■ PEEC (AICPA)

Proposed Revised AICPA Code of Professional Conduct. Comment deadline: Aug. 15. ED available at tinyurl.com/cmlk8ws. ❖

Joining Forces

The merger of Baker Tilly Virchow Krause LLP and Holtz Rubenstein Reminick LLP closed June 1. Other major firm mergers in recent years include:

Date	Premerger Firm Names	Current Name	Employees*	Annual Revenue*
June 2013	Baker Tilly Virchow Krause LLP, Holtz Rubenstein Reminick LLP	Baker Tilly Virchow Krause LLP	1,600	$300 million
October 2012	J.H. Cohn LLP, Reznick Group PC	CohnReznick	2,000	$450 million
July 2012	Plante Moran, Blackman Kallick LLP	Plante Moran	2,000	$375 million
January 2012	Clifton Gunderson, LarsonAllen LLP	CliftonLarsonAllen	3,600	$550 million
April 2011	Dixon Hughes PLLC, Goodman & Co. LLP	Dixon Hughes Goodman	1,700	$300 million

* At time of merger announcement

Sources: News releases.

PHOTO BY HEMERA/THINKSTOCK

Is This Client the Right Fit for Your Firm?

by Deborah K. Rood, CPA

A contentious divorce. Clients who want to file delinquent tax returns. The new client who represented himself as an upstanding businessman but has been indicted—for the third time.

After malpractice claims are resolved, CPAs often say, "I never should have taken this client." But there is a way to help prevent this type of regret.

By establishing sound client acceptance procedures, CPAs often can identify problem clients before they cause trouble. That helps firms of all sizes better manage potential professional liability risks. A disciplined approach to client acceptance also contributes to a firm's sustainable growth and long-term profitability.

BASIC STEPS FOR ALL CLIENTS AND ENGAGEMENTS

Practitioners should exercise due diligence in accepting all clients and engagements. Basic steps include:

- ***Evaluate prospective client integrity.***
  - Personally meet with prospective clients (senior management, owners, and/or directors for business clients).
  - Ask for and follow up with references, including attorneys, bankers, other business consultants, and major vendors or customers. Verify that relationships were not terminated due to disagreements regarding business operations or outstanding invoices.
  - For key executives of business clients (especially those not known by the CPA firm), ask for and follow up with personal references, including previous employers and business associates.
  - Consider obtaining a credit history for individual tax and financial planning clients.
  - If the prospective client is changing CPA firms, request permission to contact the predecessor firm to investigate issues such as the client's consideration of advice provided, integrity, ethics, reasonableness of expectations, experience and qualifications of the staff, and business policies and procedures including cooperation, timing of the engagement, and whether the client pays bills on time. The previous CPA firm can provide only limited information unless it obtains an Internal Revenue Code Sec. 7216 disclosure statement from the client. Even so, the prospective client's reaction to this request (and the response of the predecessor firm) may be indicative of the client's relationship with professional service providers.
  - Determine how the prospective client found the CPA firm. A referral from a long-term client may require a different degree of professional skepticism than someone who found the firm over the internet.
- ***Perform engagements with professional competence.*** Before agreeing to propose on or accept an engagement, consider whether the requested service can be competently provided in accordance with applicable professional standards. This includes considering whether:
  - The service is within the experience and expertise of the CPA firm;
  - The engagement is consistent with the CPA firm's vision or business plan;
  - The service requires specialized skills or industry expertise;
  - The CPA firm's resources, including personnel, are sufficient to meet the needs of the engagement (e.g., timing, report delivery date, etc.); and
  - The services requested pose independence or conflict-of-interest issues, such as those covered in the AICPA *Code of Professional Conduct* (including ET Section 100-1, along with Rules 101, *Independence*, and 102, *Integrity and Objectivity*). For instance, fees from a prospective client that would represent a significant percentage of overall firm revenue could be perceived as a threat to independence. Additionally, Interpretation 101-3, *Performance of Nonattest Services*, is particularly relevant when both attest and nonattest services may be performed.
- ***Consider risks related to the particular engagement.*** This is a broad and imprecise activity and requires the attention of an experienced member of the CPA firm. It may include the evaluation of factors relevant to a specific engagement and prospective client, such as:
  - The company's financial condition/status;
  - The company's current and future economic and regulatory environment;
  - The business acumen of company management;
  - Turnover in company management and staff;
  - The intended use of the CPA firm's work product;
  - The company's proclivity to litigate as a means of resolving disputes; and

PHOTO BY FUSE/THINKSTOCK

- Additional criteria that should be developed related to the profitability and realization for the engagement.

HIGHER-RISK ENGAGEMENTS

Going beyond the basic steps described above may be warranted based on the results of performing these steps and other relevant factors pertaining to the type of client, service requested, and other identified risks.

For higher-risk engagements, consider:

- Performing a background check on key members of the company's management. This might include a survey of bankruptcy proceedings, judgments, tax liens, credit records, regulatory and licensing actions, and civil and criminal records; and verification of prior employment history, credentials, and current and past business ownership.
- A review of the entity's public records, including financial ratings, for an audit or attest engagement;
- Interviews of selected employees performing tax and accounting functions to assess their perception of the company's control environment and the entity's recordkeeping practices;
- A detailed review of previous financial statements, including the reasons for any delays in issuance or restatements;
- For prospective clients that are publicly held, have expanded rapidly, or are in rapidly changing or regulated industries, their history of changes in CPA firms. Depending on the results of this investigation, consider contacting more than one predecessor firm for additional information.
- A detailed review of previous tax returns, recent tax return audit results, and other pending tax issues.

FORMALIZE THE PROCESS

Firms should develop a new client acceptance checklist to document the decision-making process. The checklist should identify what the firm deems important and provide a written record of representations made by prospective clients and why the firm accepted them.

Larger firms may want to establish a new client acceptance committee that includes senior members of management and the accounting department. The committee meets with the relationship partner to provide a more objective evaluation of prospective clients and has the authority to reject them on behalf of the CPA firm.

Firms also should consider developing an ideal client prototype. The prototype can be compared to the prospective client to determine whether it is a good fit for the firm. While few prospective clients may be "ideal," deviations from the ideal should be documented and justified before the prospect is accepted. This process is especially important for prospective clients who present increased risks.

Finally, when the decision is made to accept a new engagement, an engagement letter should be drafted and, for high-risk engagements, reviewed by the committee before it is sent to the client. No services should commence until the client has signed the engagement letter. "In three out of every five tax claims currently being litigated against CPAs," said Alvin Fennell, vice president of underwriting at Aon Affinity, "the CPA firm's failure to use an engagement letter was a contributing factor in the filing of the lawsuit. Getting into the practice of having an engagement letter signed beforehand is a good way to protect yourself."

> An engagement letter should be sent to each new client. No services should begin until the client has signed the engagement letter.

CONTINUING CLIENTS

A similar evaluation should be conducted annually with continuing clients. Even a great client should be reevaluated, especially when management or the financial environment changes or when services are requested in connection with a planned or prospective business transaction.

IT'S GOOD BUSINESS

Prudent risk management requires that a CPA firm know as much as possible about a prospective client *before* the engagement is accepted. Forgoing client acceptance procedures can lead to unwanted surprises, including staff frustration and write-offs of billable hours or unpaid fees as well as professional liability concerns. Performing this analysis before the prospective client is accepted allows the CPA firm to weigh the risks and rewards of the engagement. ❖

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Continental Casualty Co., one of the CNA insurance companies, is the underwriter of the AICPA Professional Liability Insurance Program. Aon Insurance Services, the National Program Administrator for the AICPA Professional Liability Program, is available at 800-221-3023 or visit cpai.com.

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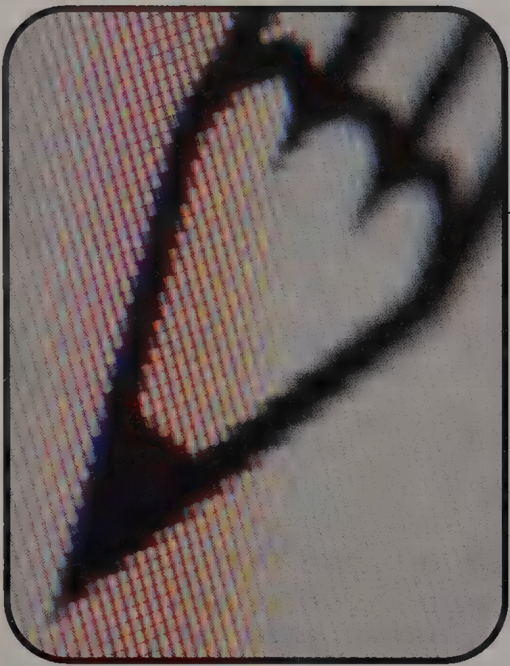

Put COSO Update to Work

Here is how organizations can implement the newly updated, principles-based internal control framework of the Committee of Sponsoring Organizations of the Treadway Commission (COSO), which was released May 14 (visit ic.coso.org). The original 1992 framework has been sharpened and refreshed to reflect the current business environment.

✔ ***Create a team and a plan.*** In many cases, the CFO will oversee implementation of the COSO framework in conjunction with the chief compliance officer and chief risk officer. Internal auditors can play a valuable support and evaluation role but will need to preserve their ability to be objective for future audits. The CEO, audit committee, and board of directors will need to be kept informed on objectives and progress. What are the time commitments required of parties involved, including external auditors? You need to have a plan.

✔ ***Use a building-block approach.*** Use the five components of the framework (control environment, risk assessment, control activities, information and communication, and monitoring activities) to break the project into workable pieces. Then focus on making sure the principles in each component are all operating together as they should. As in the past, this requires a significant amount of judgment.

✔ ***Build off what you're currently doing.*** Companies that are well controlled can build on their internal control system already in place. Some may need to refocus or refine control processes or just update their documentation. Seventeen principles are specified across the five components of internal control in the updated framework and will guide you. Mapping the principles to your controls may be a helpful exercise.

✔ ***Pay attention to the points of focus.*** Each of the 17 principles is accompanied by points of focus to consider. Although some may not apply in all circumstances, they provide excellent insight as a guide to implementation and evaluation.

✔ ***Use the* Illustrative Tools *and* Internal Control Over External Financial Reporting: A Compendium of Approaches and Examples *documents that accompany the framework.*** The examples in the *Compendium* should give great ideas in applying the framework to a specific situation. The *Illustrative Tools* document contains templates for evaluating and documenting effectiveness of internal control.

✔ ***Focus on the role of IT.*** Changes in technology were a driving force in the decision to update the framework. Consider how IT is being used, focus on recent developments such as cloud computing and social media, and take into account the implications technology has for internal control.

✔ ***Look for added value.*** Don't just approach implementation as a necessity for compliance. Use this as an opportunity to find ways to improve effectiveness and increase the efficiency of your control system. Set goals for what you want to achieve in implementing the framework beyond just compliance.

✔ ***Make the switch.*** COSO is not a standard setter and does not have power to require an organization to switch from the 1992 framework to the updated version. But after the transition period ends on Dec. 15, 2014, COSO will consider the 1992 framework to be superseded. Public companies will have difficulty explaining why they are referencing the prior version once the transition period ends. Meanwhile, during the transition period, make sure you indicate which version of the framework you are referencing.

Editor's note: COSO is a joint initiative of five private-sector organizations, including the AICPA, which provides thought leadership on enterprise risk management, internal control, and fraud deterrence.

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FROM CGMA MAGAZINE
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Five Skills That Distinguish Innovators

In today's hyper-competitive global marketplace, the ability to consistently generate valuable products separates top performers from mere observers. At the heart of every growth strategy, people play a key role in crafting a company's capacity to develop and implement disruptive ideas. Too often, however, finance executives are sidelined in conversations about innovation—or worse, they're described as inhibitors of the creative process.

The truth is: Management accountants play an integral role in fostering a company's culture of innovation, empowering leaders to tap their full creative capacity and directly contributing to the development of new offerings.

Many finance executives already exhibit strong delivery skills—which are crucial to successfully implementing new ideas. But as these same executives spend more time developing the key *discovery* skills—questioning, observing, networking, experimenting, and associating—they will be better equipped to recognize the importance of innovation in company growth. They'll also get better at developing metrics that allow for long-term innovation, and more frequently bring their own creative solutions to the table.

Finance departments today are taken to task when they fail to mitigate risk or do not meet compliance standards. These expectations push finance executives to be viewed as the voice of caution, a skeptic, and the devil's advocate in boardroom discussions.

This role certainly has its place; however, elements of the way finance executives view their function can be adapted to better enable and accelerate growth. These elements include gaining a better understanding of the role delivery skills play in the innovation process, improving their discovery quotient, and encouraging themselves and their organizations to take a long-term view.

Innovation can be divided into three segments—discovery, development, and delivery. Those in finance or accounting shine when it comes to four key delivery skills: analyzing, planning, detail-oriented implementing, and self-disciplined executing. With finance executives acting as the organization's gatekeepers and stewards of records and resources, it is no surprise these are the skills that are emphasized, valued, and promoted. This delivery-driven skill set is an important complement to discovery-driven organizations and teams.

The fastest way for an organization to die is to stop executing. Discovery-driven leaders need the delivery-driven skills of people who excel at execution. Savvy executives and managers remember how each of these skill sets of discovery, development, and delivery complement each other; and those in financial roles need to proactively lend their strengths as executors to the team's success.

Five key discovery skills distinguish innovators from typical executives. These "action-oriented" discovery skills help increase

the stock of building-block ideas from which innovative ideas can emerge.

- "Associating" or "associational thinking" is the most important discovery skill. Associating happens as people synthesize and organize novel inputs. Individuals with strong discovery skills are able to make connections across seemingly unrelated questions, problems, or ideas—intersections where innovative breakthroughs often take place.
- Asking provocative questions to challenge the status quo.
- Observing the world as an anthropologist would to detect new ways of doing things.
- Networking with people who are in various walks of life and who come from different viewpoints to gain radically different perspectives.
- Experimenting relentlessly to test new ideas and try out new experiences—continuously learning from the results.

It is increasingly important for finance executives, as confidants, advisers, and key decision-makers, to have the courage to innovate. By looking past short-term demands and criticisms, they give organizations the breathing room required to discover, develop, and deliver game-changing results.

Every individual has a more untapped creative capacity than he or she may realize. As finance executives internalize this truth, and work to improve these skills, they will lead more fulfilling professional lives, with valuable insights that will undoubtedly secure the welfare of their organization today and well into the future.

A full version of this article, "Cultivating Innovation," by Hal Gregersen, is available in the Summer 2013 print issue of *CGMA Magazine* or at cgmamagazine.org.

Also in the Summer 2013 print edition:

- Executives at Domino's Pizza and several reputational risk experts share the secrets to repairing inevitable reputational dents.
- Retired Coca-Cola finance executive Doug Bonthrone, CGMA, describes how to keep continuous improvement flowing.
- Ravichandran Venkataraman, CGMA, senior vice president and head of the Global Business Services division at Hewlett-Packard, offers tips on how to foster innovation.
- McCormick & Co. executive Ken Kelly, CPA, CGMA, explains how cross-functional, self-governing employee boards help the global spice company identify business process improvements.
- Bernard Marr, CEO of the Advanced Performance Institute, explains the differences between companies that merely compile data and those that thrive from it.
- Aidan Goddard, CGMA, the CFO and COO of L'Occitane en Provence's Asia-Pacific operations, explains how his company harnesses Big Data to cut costs while improving sales and marketing strategies.
- Priscilla Mutembwa, CGMA, of Cargill Cotton Zimbabwe offers insight from an industry and economy that are defined by uncertainty.

—Jack Hagel, editorial director
CGMA Magazine

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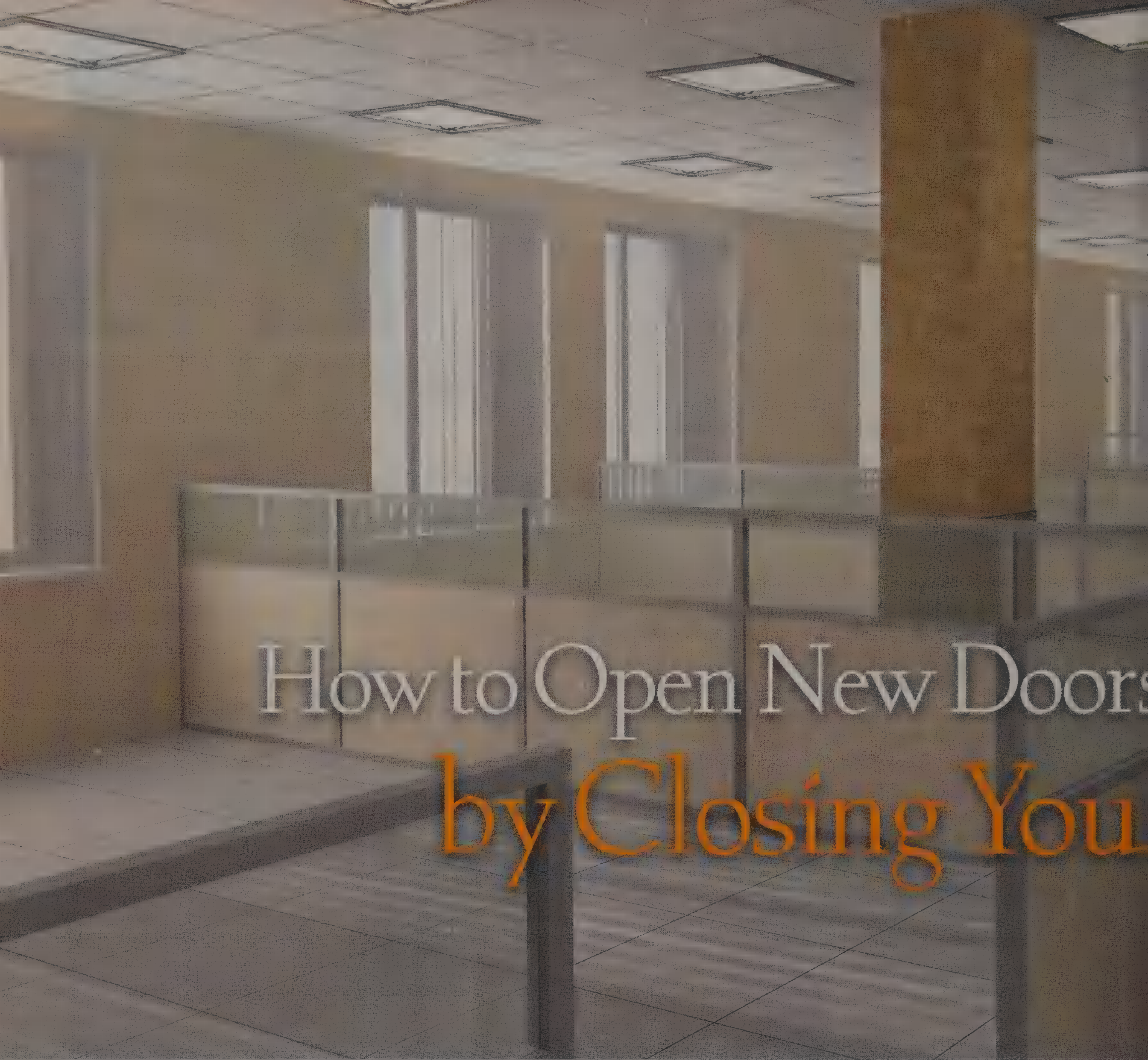

How to Open New Doors by Closing You

Firms that go virtual the right way can enjoy real savings and benefits.

by Jeff Drew

Virtually no one who has leased office space has enjoyed writing that rent check every month. It might have been satisfying at first, when the firm or company was young and having an office was a sign of progress, but watching money go into a landlord's pocket inevitably gets old.

Still, the reality was that for most multi-employee businesses, the brick-and-mortar office was foundational to the organization's existence. Physical presence announced reliability and permanence to current and prospective clients. A physical office also was deemed necessary for employee collaboration and client meetings. Consequently, the monthly lease or loan payment was considered an unavoidable part of doing business.

That mindset is beginning to change. Cloud-computing and paperless technologies are rewriting the rules for many

businesses, and not just in the areas of client service and product delivery. The same forces that are opening new markets and geographies for accounting firms (see the *JofA* article "From 'Write-Up' to Right Profitable," April 2013, page 24) are making it increasingly possible for practices to close their brick-and-mortar offices and go 100% virtual, with all processes based in the cloud and all employees based out of their homes.

In the public accounting space, many new practices start completely virtual, and many sole practitioners have operated out of their homes for years. Erik Asgeirsson, president and CEO of AICPA technology subsidiary CPA2Biz, estimates that 5% to 10% of all accounting firms are operating without a brick-and-mortar office, and he expects those percentages to continue to rise.

Business Management Resource Group (BMRG) and Blumer & Associates are a pair of firms that closed brick-and-mortar offices last year and moved to fully virtual setups. The firms have encountered challenges with shuttering their physical office operations and building camaraderie among employees working remotely, but they also have enjoyed substantial financial, staffing, and operational benefits.

Is going virtual a realistic option for your firm or business? What is required to make such a leap? How long does the process take? What are the benefits and drawbacks? This article addresses those questions and more, drawing upon the experience of CPAs already operating in their own virtual realities.

A Tale of Three Firms

Carolyn Sechler, CPA, is a pioneer in virtual offices. She formed her firm, Arizona-based Carolyn Sechler CPA PC (a B Corporation), as a two-employee operation when she de-merged from another firm. More than 17 years later, she heads a 20-person virtual operation with team members in three states and Canada. The firm works exclusively with nonprofits, providing tax and other services.


Carolyn Sechler


Jason Blumer

"We did more than 400 Form 990s last year," said Sechler, who is also a *JofA* editorial adviser. "Most of my clients, and some of the people I work with, I've never met."

For Jennifer Katrulya, CPA/CITP, CGMA, and Jason Blumer, CPA/CITP, the decision to take their firms completely virtual was a natural extension of their business plans. Katrulya, founder and CEO of Connecticut-based BMRG, and Blumer, owner and chief innovation officer of Blumer & Associates in Greenville, S.C., had converted their firms to cloud-based models that allowed them to pursue niche offerings with clients far beyond their home areas and even internationally. Katrulya grew her business by providing outsourced controllership and other accounting services to clients referred by venture capital firms. Blumer focused his firm on serving exclusively "creative" clients, including advertising agencies.

During the evolutionary process, both firms expanded their staffs and in a quest for talent hired some employees in locations far from their brick-and-mortar offices. Even many local employees began to frequently, and often exclusively, work from home.

Katrulya noticed an increasing number of unused work spaces in her office and began to envision life without having to write those pesky rent checks. Blumer looked around his office, saw virtually no one else there, and decided that it was time his office situation reflected reality. In 2011, both firm owners decided to begin the journey to a fully virtual environment.

IS VIRTUAL THE RIGHT FIT?

The first step on the path to a virtual reality is determining whether your firm is suited for the journey. "The wrong team cannot go virtual," Blumer said. "Going virtual is not a strategy. Rather, you should consider it as a preferred means of service to the right kind of customer. It's a special setup not suitable for many firms, but for the right firm, it is a gift to your team to manage themselves and become more productive."

Virtual firms operate best with employees who are self-starters and can work alone without getting lonely, Sechler said. The officeless environment lends itself naturally to flexible schedules and production-based, or results-only, models. "We have people on my team who are raising small children," Sechler said. "We have one that's taking care of a senior member of the family. They work whatever hours they need because their performance is evaluated on a performance-oriented basis. That works really well for us."

How can a firm tell if it's a good fit for the virtual world? An organization with no office has no place to store paper or house its own computer servers. Cloud-based servers and applications, accessible by clients and firm personnel, are essential for a virtual firm, which must work largely paperless. If, in addition, employees rarely work in the office and clients seldomly pay visits, the firm could be primed for going virtual.

Once a decision to go virtual has been made, firms must begin a preparation and transition phase that can last from one to three years, with 12 to 18 months being a good target. Firms must address a plethora of cloud, process, and administrative issues before they can close their physical address.

TAKE YOUR TIME, DO IT RIGHT

Firms looking to shed their rent payment might be tempted to rush the process. That would be a mistake, according to Katrulya and Blumer. A steady, measured move to a virtual environment makes the process much more manageable.

BMRG and Blumer & Associates had already converted to cloud-based business models, giving them a head start on the transition process. Even so, Katrulya spread the transition out over the course of a year, reducing BMRG's office space by 50%, from 2,400 square feet, before finall[y] exiting the space. During that period, he[r] employees worked more frequently from home, keeping in place the safety net of the office when employees ran into problems.

Blumer tweaked his firm's structure and parted ways with his tax specialis[t] when he decided during his yearlong transition period to outsource tax services. He has six employees and contractors, up from five when he closed the firm's office last year.

THE VIRTUAL ADVANTAGES

Firms that go fully virtual can save som[e] real money on rent and office expenses. Blumer & Associates has shaved "a few thousand dollars" a month in rent payments, but Blumer has not pocketed tha[t] cash, he said. Instead, he has opted to fun[d] new profit-sharing payments for employees and to purchase better cloud technology, as well as Apple laptops and iPhone[s] for the staff.

For BMRG, vacating its office and goin[g] fully paperless has translated into saving[s] of more than $95,000 a year, said Katrulya. That figure is in line with the average annual rent of about $100,000 reported b[y] the 2,362 firms polled in the 2012 AICPA Private Companies Practice Section/Texa[s] Society of CPAs Management of an Accounting Practice (MAP) survey. For smal[l] and midsize firms, rent and other occupancy costs represented between 6% an[d] 7% of net client fees.

"The two greatest advantages to me are, by far, the financial savings and the abili[ty]

EXECUTIVE SUMMARY

- **Cloud-computing and other technologies** are making it increasingly possible for accounting firms to close their brick-and-mortar offices and go virtual.
- **CPA firm owners who have taken their firms virtual** recommend allowing one to three years for the transition, with 12 to 18 months as a good goal. The transition period is essential to ensuring that employees and clients are prepared for the new virtual realities.
- **Firms must complete a long list of critical tasks** before vacating their office (see the sidebar, "What Firms Must Do Before Going Virtual"). Chief among those tasks are writing and implementing a document detailing protocols employees must follow and outlining policies regarding privacy, risk management, human resources, and other issues.
- **The firms best suited for the virtual world** are those with employees who are self-starters and don't get lonely easily. Employees who work better around other people aren't well-suited for a virtual setup.
- **Going virtual can save accounting firms** tens or even hundreds of thousands of dollars a year in rent.
- **Other benefits to the virtual firm include** the ability to hire employees no matter where they are located and greater potential compensation for staff due to the savings on rent.

Jeff Drew is a JofA senior editor. To comment on this article or to suggest an idea for another article, contact him at jdrew@aicpa.org or 919-402-4056.

ty to hire top talent wherever they are located," said Katrulya, who doubled the size of her firm with an acquisition that closed in May. She now has 24 employees, with a dozen in California, six in New York, four in Connecticut, and one apiece in New Hampshire and Ohio. Blumer's six-person workforce is based in South Carolina and Colorado.

Among the other advantages of going virtual are:

- The ability to provide flexible work schedules, especially when clients and employees are located in different time zones. Telecommuting arrangements also make it easier for employees to take "working vacations." Katrulya, for example, was able to extend a business trip to California and visit family for several days before returning home to Connecticut. The trip would have been impossible without the ability to telecommute.
- Access to a more diverse range of client opportunities, because the cloud eliminates geographic barriers by allowing CPAs to collaborate in real time with clients anywhere in the world. The broadening of the client-prospect pool can help the firm attract better talent to the employee ranks.
- Greater potential compensation for staff due in large part to the savings in rent and other office occupancy costs. "We can take the funds we would be investing in overhead and instead allocate that to salaries, professional development, and other employee offerings," Katrulya said.
- Improved understanding of the firm's services, niche, and value. "When you operate in a more 'traditional' model, the value of your services, your processes, and your team are less explicit," Blumer said. "Becoming virtual has taken away all of the superfluous things that kept us from focusing on our real results that we sell to our customers. It has allowed us to price our services more profitably and more effectively."
- Tax benefits for the employees. CPAs working from home also can claim a home office tax deduction, provided they meet IRS requirements for doing so (see the article "IRS Offers a New Method for Home Office Deductions" on page 30).

The virtual experience also can provide CPAs with knowledge that clients could find valuable. "We have a number of clients who travel a lot for their own business development," Katrulya said. "So testing out the process of not only working virtually but also 'taking it on the road' that way gives me a great way to live the way they live and explore new technology solutions, work flow procedures, staff management practices, that I can then use to be a more knowledgeable and effective business adviser to them."

Challenges of the Virtual Office

The biggest challenge with the virtual office is establishing and maintaining a sense of camaraderie among employees who rarely are in the same building, much less the same room. Firms must develop strategies for ensuring that team members stay connected to one another and also to the firm's mission, goals, and values.

"I believe we miss being together on a daily basis," said Blumer, who augments his firm's weekly online staff meetings with staff retreats. "We have had to be very specific about spending time together a couple of times a year just to enhance our team's culture. Our times together during our live firm retreats are welcome times to relax with each other and get to know each other better."

Both Blumer and Katrulya try to get their teams together at least twice a year. Katrulya also tries to get her team to conferences so they can learn and develop camaraderie.

Still, challenges remain in trying to develop a work culture. "You can't just pick random days to take everyone to lunch, there is no 'water cooler' time (which has some advantages), and staff may otherwise work together for months and never really meet face to face," Katrulya said. "In addition, if performance issues arise, as a manager it is much more difficult to have those discussions via phone/video call, etc., versus meeting in person."

Firms also must plan ways for staff members to share knowledge with one another. "Knowledge is shared in an office by walking down the hall, buzzing someone's phone, or saying something at the coffee pot in the morning," Blumer said. "These are interactions that do not, and cannot, happen in a virtual setting. So, what do you do? You become strategic."

A steady, measured move to a virtual environment makes the process much more manageable.

Blumer & Associates is experimenting with chat clients, including HipChat, Hall.com, Flowdock, and Campfire, that are scalable, private, secure, and searchable, and allow team members to talk over video.

Other challenges include:

- Dealing with the privacy, insurance, human resources, zoning, and other issues detailed in the sidebar, "What Firms Must Do Before Going Virtual." Failure to do so can lead to myriad problems. Detailed diligence is required in these areas.
- Ensuring the firm's CPAs are licensed to work with their clients. Even with mobility legislation passed in almost every state, differences in the wording of the legislation in individual states can make it more difficult to determine if a state license is required for a CPA to work with a client based in a certain state.
- Having the IT skills needed to thrive in the virtual space. Because technology is so essential to a successful

What Firms Must Do Before Going Virtual

Accounting firms must do the following before closing their brick-and-mortal office and going virtual:

- ***Adjust or take out new insurance policies to cover the new virtual realities.*** For instance, if CPAs in a firm will meet clients at their home office, they should add riders to their home insurance policy protecting them in case of injury, such as a client slipping and falling, said Carolyn Sechler, CPA, of the Arizona-based firm Carolyn Sechler CPA PC. Changes also should be made to cover liability for lost papers and other privacy issues. Firms should ensure employees make clear in their insurance riders that they work for the firm. It's also a good idea for employees to cover their cars under the firm if they use them for business, she said.
- ***Implement laser-focused, linear processes that can survive the strain of an officeless environment.*** "When you are in an office and you have the ability to lean over your cube and ask a question, or catch a client as they come in to pick up their tax return, or walk down the hall to ask someone to clarify something, you realize that these *all* have to be straightened out when going virtual," said Jason Blumer, CPA/CITP, of Blumer & Associates in Greenville, S.C. As an example, Blumer discussed what happens when a tax client comes by the office.

  "You are really doing [at least] three things when that customer comes by," he said. "One, sharing with them the details of their return and why things turned out the way they did; two, getting them to sign some documents before you efile [often both spouses have to come]; and three, getting paid."

  While the CPA firm can adjust on the fly to make sure those goals are met during a client visit, that isn't possible in the virtual space. As a result, firms must ensure that their process addresses all of the essential steps and does so in the correct order. "That is, one comes before the other and *cannot* come after the other," said Blumer. "If they are not linear and well-designed, then the customer gets confused and a little miffed."
- ***Write and employ an office policy document that outlines the protocols employees must follow while working for the firm.*** The document should cover policies designed to mitigate the firm's risk from encountering problems with privacy, risk management, and human resources issues.
- ***Ensure the firm complies with all laws and regulations overseen by the state labor departments in the areas where the firm has employees.*** Sechler recommends having a human resources professional look over all written policies to ensure they are in good order.
- ***Notify clients about the office closure and why it's happening.*** Clients who balk at going virtual probably aren't right for the move. "You cannot take the wrong clients virtual," Blumer said. "They will laugh in your face." Some clients just prefer to have a CPA in a larger practice or with a brick-and-mortar office, Sechler said.
- ***Find out whether local regulations and/or homeowner association (HOA) rules allow employees to operate home offices.*** Some zoning ordinances and HOA charters don't allow home-based businesses to accept client or customer visits. Similarly, some vendors won't deliver to home addresses, Sechler said.
- ***Have the right technologies in place to support the virtual office structure.*** At the staff level, the firm must ensure that each employee has adequate and redundant internet connections and proper levels of technology at home. Other technology issues that must be addressed include the following:
  - At a minimum, each employee needs two internet connections, such as cable and DSL or a mobile hotspot (e.g., a MiFi device), with one acting as the lead connection and the other as a backup. Connecticut-based Business Management Resource Group (BMRG) pays for the second source for its employees. "Usually they have cable, and we are paying for either DSL or MiFi," said Jennifer Katrulya, CPA/CITP, CGMA, of BMRG.
  - The firm should know whether each staff member has a generator in the event of a power outage. In addition, employees must have extra laptop batteries available, and the firm must have a procedure in place to remind staff to keep spare batteries charged. On the plus side, having employees in different parts of the country, or world, can lessen the chance of a weather event knocking everyone in the firm offline.
  - In addition to laptops, all employees should have smartphones and, preferably, tablets. Firms can provide the equipment or provide a stipend in a bring-your-own-device structure.
  - The firm needs to have a plan for handling incoming phone calls, whether it's a phone service or something else.
  - Cloud-based applications are essential for a virtual office. Cloud-based accounting systems include QuickBooks, Xero, and Intacct. There are a number of work flow, billing, tax preparation, accounting engagement, and file-sharing options as well.
  - Customer-relationship management systems play a crucial role in making a virtual office successful.
  - The firm must have communication tools in place to facilitate staff interactions with clients and one another. Important considerations include whether the communication—email, instant messaging, video conferencing, or something else—is recordable and meets documentation-retention standards.

Jennifer Katrulya says going virtual with her firm has saved money and helped her hire top talent.

virtual practice, firms cannot survive without a strong source of IT aptitude among the staff or, possibly, a consulting relationship.

- Maintaining work/life balance. Because virtual office setups provide employees with the opportunity to work anytime, anywhere, it's easy to fall into a pattern of working virtually all the time from everywhere, especially when clients and staff are spread across multiple time zones. If a firm has clients overseas, it can become possible to work with clients 24 hours a day. Firm leadership needs to help owners and staff employ strategies to avoid continual work distractions, such as email, while also emphasizing the importance of time away from the office. "It takes a while for staff to feel like they can really unplug as well, go on a true vacation, etc., because they care about our clients and the company and want to be sure that they are involved," Katrulya said. "We have actually needed to really work on giving each other that true offline time."
- Dealing with distractions at home. While telecommuting can tether a professional to work, life in a home office can divert one's attention from the task at hand, especially if children are at home during work hours or there is other activity at the home. Katrulya, for instance, found her home work schedule turned upside down when her family brought home two kittens. She allowed the pets into her office, where she even allowed them to sleep. As they grew, they took up more of her time and attention. "I needed to truly make my home office the office and then save the fun time in the rest of our home for later," she said. "Otherwise I was working all night to try to make up for the fun hours of playing with the little fur-balls!" ❖

AICPA RESOURCES

JofA article

- "From 'Write-Up' to Right Profitable," April 2013, page 24

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Publications

- *10 Steps to a Digital Practice in the Cloud: New Levels of CPA Firm Workflow Efficiency* (#PTX1204P, paperback; and #PTX1204E, ebook)
- *Quantum of Paperless Guide*—digital best practices (online-only, free to PCPS members, tinyurl.com/opgcjt3)

CPE self-study

- The Changing World of Internal Control: Managing Risk in the New IT World (#733521)

Conference

- Digital CPA: 2013 CPA2Biz Cloud User Conference, Nov. 20–22, Washington

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The Private Companies Practice Section (PCPS) is a voluntary firm membership section for CPAs that provides member firms with targeted practice management tools and resources, including the Succession Planning Resource Center, as well as a strong, collective voice within the CPA profession. Visit the PCPS Firm Practice Center at aicpa.org/PCPS.

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In an effort to better recognize and support the breadth of its members' professional duties and responsibilities, the AICPA has changed the name of the Information Technology Section to the Information Management and Technology Assurance (IMTA) Section. The IMTA division serves members of the IMTA Membership Section, CPAs who hold the Certified Information Technology Professional (CITP) credential, other AICPA members, and accounting professionals who want to maximize information technology to provide information management and/or technology assurance services to meet their clients' or organization's operational, compliance, and assurance needs. To learn about the IMTA division, visit aicpa.org/IMTA.

IRS Offers a New Method for Home Office

Safe harbor simplifies calculation, but qualification factors are unchanged.

by Sally P. Schreiber, J.D.

Working at home has come a long way from the days when employers were most concerned that they would not get their money's worth if they allowed employees to do so. Instant communication, improved internet access, and more stable virtual network connections have changed the equation for employers, who now see the ability to work at home as benefiting both sides: employers and employees.

Although estimates vary, one source says that the number of workers regularly telecommuting (more than one day a week and not including the self-employed) grew 73% between 2005 and 2011 (*Latest Telecommuting Statistics*, available at tinyurl.com/a7tzewp (updated Oct. 2012)). The same source asserts that if those who have jobs that are compatible with working at home and would like to do so were permitted to work at home at least half the time, annual savings would be greater than $700 billion. This includes savings of $11,000 per person a year for the typical business and savings of $2,000 to $7,000 a year for the typical telecommuter.

In contrast to employees, the number of self-employed people working from home actually decreased during the recession. As the economy recovers, however, the number of businesses in homes should also increase.

As more people telecommute from home and people who lost jobs in the recession start businesses in their homes, it is a good time to revisit the tax rules that apply when people work from their homes. The rules are complex, so it is important to fully understand them to comply and thus withstand a possible IRS challenge. The rules to qualify are different for employees than for the self-employed, as are the procedures for claiming the deduction on a tax return.

The IRS recently announced a safe-harbor method that will make it easier for taxpayers who choose the safe harbor to take the deduction, so practitioners may see an increase in clients who want to take the deduction. However, the basic qualification rules have not changed, so an understanding of them is still important.

Deductions

The Statutory Requirements

A deduction is permitted for expenses associated with that portion of the dwelling unit that is exclusively used on a regular basis either (1) as the principal place of business for any trade or business of the taxpayer; (2) as a place of business that is used by patients, clients, or customers in meeting or dealing with the taxpayer in the normal course of his or her trade or business; or (3) in the case of a separate structure that is not attached to the dwelling unit, in connection with the taxpayer's trade or business.

For purposes of (1) above, the term "principal place of business" includes a place of business that the taxpayer uses for the administrative or management activities of the taxpayer's trade or business if there is no other fixed location for the trade or business where the taxpayer conducts the substantial administrative or management activities (Sec. 280A(c)(1), flush language).

There are also special rules for use of a portion of the home as storage space or to provide child care facilities, which are not addressed in this article.

In most cases, the office must be the principal place of business for *any* trade or business of the taxpayer, which has been interpreted as meaning that "expenses attributable to the use of a home office in conducting two or more separate business activities may be deductible" (*Hamacher*, 94 T.C. 348, 356 (1990)). However, if a person uses one home office for numerous business activities, each activity must meet the requirements under Sec. 280A, or they will all be disqualified (id.).

For the use of a home office by an employee to qualify, the use must be for the convenience of his or her employer (Sec. 280A(c)(1), flush language). Also, if the employee rents a portion of his or her home to the employer and uses the rented space to perform services as an employee for that employer, the employee cannot take a home office deduction for expenses related to that part of the employee's home (Sec. 280A(c)(6)).

> To qualify for a deduction, a home office must be used for business exclusively and at all times, and any use for a nonbusiness purpose disqualifies the space.

Exclusive Use on a Regular Basis

According to the IRS, to qualify for the "exclusive use" test, taxpayers must use a specific area of their home exclusively for their trade or business, but the area does not need to be set off by a permanent partition. However, it must be used for the trade or business exclusively and at all times (not just during business hours), and any use of the space for nonbusiness purposes disqualifies the area, e.g., an office that is also used as a family room will not qualify. So, for example, where an accountant's children and guests occasionally used the bathroom and hallway adjacent to his home office (and built for the use of his clients), that portion of the house did not qualify for the home office deduction (*Bulas*, T.C. Memo. 2011-201).

To qualify for regular use, the specific area of the home must be used on a regular basis; occasional or incidental use will not qualify. This determination is made based on all the facts and circumstances (see Publication 587, *Business Use of Your Home (Including Use by Daycare Providers)*).

Work at Home Is for the Employer's Convenience, Not the Employee's

Many employees who work in their homes will not qualify for the deduction because they do it for their own convenience, not their employer's.

It is not impossible to establish that the home office is for the employer's, not the employee's, convenience, but it is difficult. For example, an architect could not deduct expenses for his home office when his employer did not require him to maintain the office and he had unlimited access to his employer's downtown office (*Tokh*, 25 Fed. Appx. 440 (7th Cir. 2001)).

If the use of the home office is necessary to allow the employee to perform his or her duties as an employee properly, or the use of the home office is necessary for the functioning of the employer's business, it will be considered to be for the employer's convenience. If the employer requires the employee to maintain a home office as part of his or her job requirements, the use of the home office is also considered to be for the employer's convenience. As more people work at

Executive Summary

- **In recent years the number of people working from home** has increased dramatically, especially for employees.
- **Using a portion of their home in a trade or business** can enable taxpayers to take a deduction for home office expenses.
- **The tax return treatment and the rules for qualifying for the deduction are different** for the self-employed and employees.
- **The rules for calculating these expenses are complex, and as a result,** many taxpayers have not wanted to risk the increased IRS scrutiny that taking the deduction might bring.
- **New safe-harbor rules make it easier to take the deduction,** although taxpayers must still meet other requirements to qualify.

Sally P. Schreiber *is a JofA senior editor. To comment on this article or to suggest an idea for another article, contact her at sschreiber@aicpa.org or 919-402-4828.*

home and are not provided a space to work at their employer's premises, it may be easier for employees to establish that it is being done for the employer's convenience, say, to save the employer on the cost of providing workspace in the company's office.

However, in the absence of a specific requirement by their employer that they work at home, when the "convenience of the employer" requirement is litigated, taxpayers in the past have usually lost. Taxpayers with the right facts and circumstances can win, though, as happened in *Drucker*, 715 F.2d 67 (2d Cir. 1983). The taxpayers in *Drucker* were musicians with the Metropolitan Opera in New York City who, the court found, had their principal place of business at their home practice studios, which was "the rare situation in which an employee's principal place of business is not that of his employer." The court found that it was a necessity for the musicians to spend long hours practicing individually to perform their jobs, and the Met did not provide space to practice privately at its performance facilities, so practicing at home was in fact a requirement or condition of employment for the musicians.

Calculating the Amount of the Deduction

Calculating the home office deduction can be done one of two ways: the actual-expense method, under which the home office deduction amount is based on the actual expenses related to the use of the home office incurred by the taxpayer, or the new safe-harbor method, under which the deduction amount is determined by a formula based on the square footage used as a home office.

Whichever method is used to calculate the deduction, the amount of the deduction is subject to a gross income limitation, which, as discussed below, is calculated differently for each method. In addition, the carryforward rules for the deduction are different under each method. Under the actual-expense method, any excess of otherwise deductible expenses over the gross income limitation can be carried forward to the next tax year, subject to the same limitation (Sec. 280A(c)(5)). If the safe-harbor method is used, the amount of otherwise deductible expenses in excess of the limitation cannot be carried forward to future tax years.

Actual-Expense Method

Under the actual-expense method, taxpayers first must determine the percentage of their home that is used for business. This can be done by any reasonable method, but the most common approaches are either (1) the square-footage approach, in which the area used for business is divided by the house's total square feet, or, (2) if the rooms in the home are all of a similar size, determining the percentage by dividing the number of rooms used for business by the total number of rooms in the house. For example, using the first method, a taxpayer whose office is 12 feet by 15 feet and whose house is 2,000 square feet uses 9% of the house in the trade or business.

After determining the percentage of the home expenses that the taxpayer can deduct as expenses for the business use of his or her home, the next step is to determine whether the deduction is subject to the gross income limitation. The deduction of otherwise nondeductible home expenses, such as insurance, utilities, and depreciation (with depreciation taken last), that are allocable to the business, is limited to the gross income from the business use of the taxpayer's home, less:

- The business part of expenses the taxpayer could deduct even if he or she did not use the home for business (such as mortgage interest, real estate taxes, and casualty and theft losses that are allowable as itemized deductions on Schedule A, *Itemized Deductions* (Form 1040)); and
- The business expenses that relate to the business activity in the home (e.g., business phone, supplies, and depreciation on equipment), but not to the use of the home itself. Self-employed taxpayers cannot include their deduction for the deductible part of their self-employment tax as expenses in the second category.

The calculation of a taxpayer's business use percentage and allowable deduction amount are performed on Form 8829, *Expenses for Business Use of Your Home*, for Schedule C filers, or on the "Worksheet to Figure the Deduction for Business Use of Your Home" in Publication 587 for employees and others.

> Under the safe-harbor method, the home office deduction is calculated by multiplying the allowable square footage, not to exceed 300 square feet, by $5.

The New Safe Harbor

In January, the IRS released Rev. Proc. 2013-13, which gives taxpayers an optional safe-harbor method to calculate the amount of the deduction for expenses for business use of a residence beginning with the current tax year, 2013, for returns filed in 2014.

Individual taxpayers who elect this method can deduct an amount determined by multiplying the allowable square footage by $5. The allowable square footage is the portion of the house used in a qualified business use, but not to exceed 300 square feet. Therefore, the maximum a taxpayer can deduct annually under the safe harbor is $1,500. The IRS may update the $5 allowance from time to time, but it is not inflation adjusted. Because the up-to-$1,500 amount is a safe harbor, taxpayers who use the safe harbor cannot also deduct actual expenses related to qualified business use of the home for that year; however, business expenses that are unrelated to the use of the home (such as advertising) can be deducted.

To use the safe-harbor method, taxpayers

must continue to satisfy all the other requirements for a home office deduction, including the requirement that the space in the residence used as an office be used exclusively for that purpose and the limitation that an employee qualifies for the home office deduction only if the office is for the convenience of the taxpayer's employer. The safe harbor is elected on a timely filed original tax return, and taxpayers are allowed to change their treatment from year to year. However, the election for any tax year is irrevocable.

No depreciation is allowed for the years in which the safe harbor is elected. This may make this method more attractive for taxpayers who do not plan to stay in their homes a long time because they will then avoid the depreciation recapture that is required of taxpayers who took depreciation on their personal residences.

A taxpayer who itemizes deductions and uses the safe harbor for a tax year may deduct, to the extent allowable, any expense related to the home that is deductible without regard to whether there is a qualified business use of the home for that tax year (e.g., deductions for qualified residence interest, property taxes, and casualty losses). Taxpayers using the safe harbor deduct these expenses as itemized deductions on Form 1040, Schedule A, and cannot deduct any portion of these expenses from the gross income derived from the qualified business use of the home, either for purposes of determining the net income derived from the business or for purposes of determining the gross income limitation discussed directly below.

Like the actual-expense method, the deduction under the safe-harbor method is subject to a gross income limitation. The amount of the deduction computed using the safe-harbor method cannot exceed the gross income derived from the qualified business use of the home for the tax year reduced by the business deductions unrelated to the qualified business use of a home. Unlike the actual-expense method, however, taxpayers cannot carry over any excess to another tax year. If a taxpayer uses the actual-expense method for calculating the deduction and has had his or her deduction limited by the gross income limitation in that year, the taxpayer can deduct this amount in the next year he or she uses the actual-expense method, but cannot use the disallowed amount in a year he or she elects the safe-harbor method. This limit on carryovers for the safe-harbor method means taxpayers must be careful before electing it to be sure they will not lose any of their deduction.

Taxpayers sharing a home (for example, roommates or spouses, regardless of filing status) may use the safe-harbor method provided by the revenue procedure, but not for qualified business use of the same portion of the home.

Under the safe harbor, taxpayers who have a qualified business use of more than one home for a tax year may use the safe harbor for only one home, but they may use the actual-expense method for the other homes. If a taxpayer has more than one qualified business use of the same home, however, and uses the safe harbor, he or she must use the safe harbor for all of the business use of the home and thus will be limited to the $1,500 deduction for all of his or her businesses in the home.

Conclusion

The digital age means more and more people are working from home offices for employers and for themselves. Recent advances in technology enable many people to set up home offices with very little trouble, as access to high-speed internet and virtual networks from the home increases. Environmental concerns will add to employers' and employees' wish to permit telecommuting to expand. And, unfortunately, during the recession, the number of underemployed or unemployed people increased, and, as the economy recovers, more of them may want to start businesses in their homes. All these changes mean practitioners and taxpayers would benefit from refamiliarizing themselves with the rules that apply to home office deductions.

The new safe-harbor method will probably induce taxpayers to claim a home office deduction who were scared off in the past—either by the deduction's complexity or from fear that it is an IRS audit "red flag." Practitioners should be prepared to help those taxpayers determine which method is better in their circumstances. ❖

AICPA RESOURCES

JofA article

- "Checklist: Home Office Deduction," Jan. 2012, page 20

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PFP Q&A: Planning for Change

Experts discuss implications of tax law changes, new standards, and the retirement of the Baby Boomer generation.

by Chris Baysden

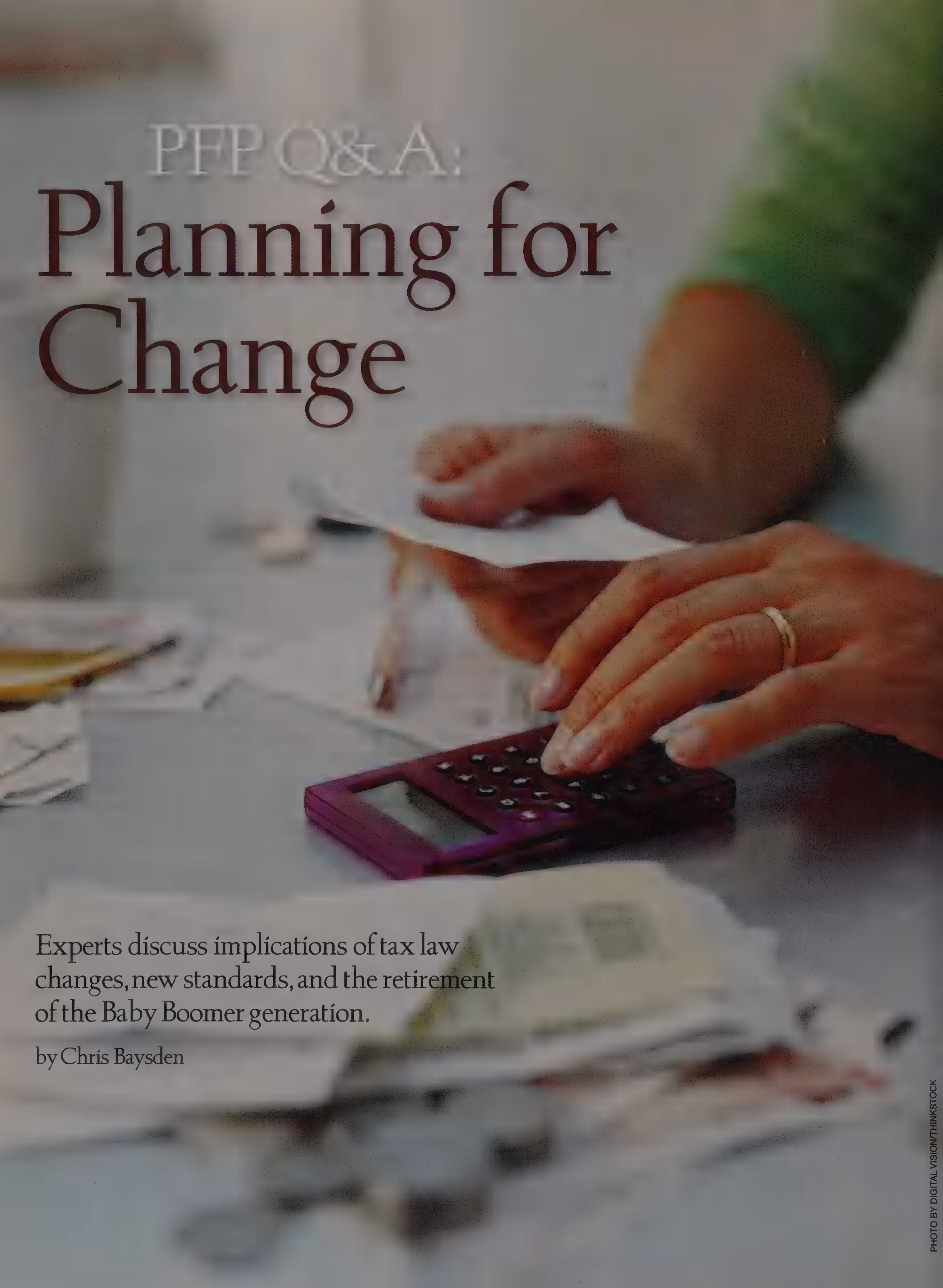

PHOTO BY DIGITAL VISION/THINKSTOCK

With the Baby Boomer generation hitting retirement age, personal financial planning has become an increasingly important service for many accounting firms. But practitioners are dealing with plenty of changes, including the implementation of new tax laws and the landmark rollout of new standards.

The *JofA* assembled a team of industry insiders for a round-table discussion of the important issues affecting CPAs who advise individual clients in retirement, tax, estate, risk management, and/or investment planning at such an important time. The following is an edited transcript of their discussion.

Participating in the round table were:

- **Clark M. Blackman II**, CPA/PFS, CFA, CFP, president and CEO of Alpha Wealth Strategies.
- **Bob Keebler**, CPA, MST, AEP, a partner with Keebler & Associates LLP.
- **Sid Kess**, CPA, J.D., LL.M., of counsel at Kostelanetz & Fink LLP.
- **Steve Levey**, CPA/PFS, senior principal and CEO at GHP Horwath and senior principal of GHP Investment Advisors Inc.
- **Scott Sprinkle**, CPA/PFS, CGMA, CFP, a managing member at Sprinkle & Associates LLC and Sprinkle Financial Consultants LLC.
- **Susan Tillery**, CPA/PFS, CFP, president and CEO of Paraklete Financial Inc.

What do you think the most important issues are for personal financial planners today?

Kess: I would say that the tax provisions enacted in the American Taxpayer Relief Act of 2012 affecting high-income taxpayers, as well as the provisions of the Patient Protection and Affordable Care Act that became effective in 2013, provide unique opportunities for financial planners. These new provisions impact everyone, not just the financial planner. In addition, the changes in the field of estate planning are also extremely important in the way they impact the high-income taxpayer.

Keebler: I think the biggest two challenges are learning the new 3.8% net investment income tax … and secondly, there are four dimensions to our income tax Code now: the traditional income tax, the alternative minimum tax, the 3.8% surtax, and the additional 39.6% tax bracket and greater capital gain tax if you're over the higher threshold. And [the challenge is] to develop a 10- or 20-year plan for most taxpayers to smooth out that income and try to avoid these additional taxes. So those are the two toughest challenges, and then the third thing is to create new tax-efficient investing strategies.

Blackman: I think a couple of things continue to get a lot of press and discussion: This whole active-versus-passive investing question, and which is the most appropriate way to go, if there is a most appropriate way to go. And using alternative investments and hedge funds as a way to mitigate risk continues to be a hot topic in the area of investment decision-making.

Tillery: The higher income tax rates are going to affect many of our clients. Quite a few have been surprised to hear how much they will be impacted. I think it will be important to explain to each client how the higher rates will affect their tax liability and begin planning now to reduce the impact on their 2013 tax returns.

Sprinkle: On the investment side, you're going to see a big push for clients that are seeking more wealth planners versus investment advisers. The tax situation is going to become so important when you're looking at the investments, and how do I allocate assets between my tax-deferred accounts versus taxable accounts? How do I deal with capital gains? We have some clients who are contemplating large asset or stock sale transactions, and they are looking at using different instruments, like charitable trusts, to defer and spread taxes on assets to stretch the gains or to shelter them and use charitable deductions, while at the same time generating income streams that provide a significantly higher yield than what is available in today's fixed-income market.

Kess: The interesting thing is a lot of these issues affect people who are not just calling themselves financial planners. … You don't have to be a financial planner to get involved with every one of those issues that were raised. A good tax person would be doing all those things that were just brought up.

"There's a tremendous need to give more intensive training to personnel to really be outstanding in different phases of [financial planning]."—Sid Kess

Can you identify some of the technology that personal financial planners now need to stay on the cutting edge of serving their clients?

Levey: I can tell you what our firm is looking for now. We want to get software that can integrate all of the investments, all of the investment statements, and all of the income tax, all at once, so that any changes instantly update across all software. We're actually hiring a firm to come in and write some software that will let our programs talk to each other so that we don't have to enter things three or four times.

What size firm do you have to be to justify that expense?

Levey: It all depends on the features you want. But I don't think it's going to be that expensive. I believe it is figuring out what you want it to look like in the future. And to give you an idea, we're using NaviPlan for our financial planning software, and we're looking to somehow be able to import data through PortfolioCenter, which is our portfolio management application, and integrate that into the asset allocation piece

of our financial planning software.

I can't give you a price on it. I could tell you, we're doing $700 million [in] assets under management. I could realistically see it costing $25,000 to $50,000, but the way you have to look at it is how much will you save in time and ... efficiency, and [be] able to concentrate on other things?

Let's talk a little about issues regarding the retirement of so many Baby Boomers.

Keebler: I think as we become more of a service economy, and people are working at desks rather than at workbenches, people are going to be able to work later, till their mind no longer permits them to work. That means a lot of people will be able to work well into their 80s. That's part of what's causing the situation with our young people not being able to find jobs: Older people continue to work, and they're good, and they add value. And the other thing we're seeing is that more and more of our clients are asking about putting a portion, maybe 10% to 25% of their net worth, into annuities when they retire so that they receive a payment each month and they're pretty much guaranteed some level of cash flow.

What will be the impact of the retirement of Baby Boomers working in the CPA profession, especially personal financial planners?

Sprinkle: I think for the profession as a whole, people are working longer, but you are going to end up in a situation where we're going to have a brain drain, and you're going to have to start developing younger individuals.

And for whatever reason, maybe it's complexity, maybe it's because of the way the financial markets have gone, or some of the larger firms are not doing financial planning the way they used to, but the avenue to get into this profession is difficult because there's so much you have to learn. There's such a broad knowledge base that you have to develop. And there are not a lot of universities that offer programs that can get you up and running. There are a few universities that have financial planning as a major, but even then, there is no substitute for experience.

> "Your people skills are what really differentiate you from your competitors."
> —Scott Sprinkle

It's going to be a challenge for a lot of firms; the succession issue is going to become a large issue, and you are going to end up seeing bigger firms emerge, as they will be the only ones with enough capital to consolidate smaller practices. The lack of succession planning along with a limited market could result in retiring advisers settling for a lower market price for their firms.

Levey: I'm 61. I'm pleased to tell you that the president of our investment company is 45 years old. We have three new partners who are in their mid-30s.

What we needed to do was provide a career path for them, including incentive compensation and ownership in the company. You've got to plan, and as much as people are working longer, accountants also have to understand that they don't want to stand in the way of other people. They have to [create] a culture [where] they're willing to train and develop new leaders and give those people new responsibilities.

Tillery: Our succession plan is to duplicate ourselves. This allows us to build more and more value into our firm, as well as train the firm's next group of leaders. When my business partner and I decide to sell the firm, not only will we know the firm is in good hands, but the new owners will have value worth purchasing.

Kess: I wanted to bring out something that I think is very important. Just sending someone to a meeting, like a financial planning conference or a tax strategy conference—people really can't learn enough. And I think the training for many people is really inadequate to be an outstanding financial planner. You just don't come to a lecture on estate planning and now you're an estate planner. There's a tremendous need to give more intensive training to personnel to really be outstanding in different phases of this work.

Keebler: It is a major-league challenge, training young people, because most of us put together this skill set over 20, 25 years. The only way to walk in relatively competent—a person would probably need their CPA and some type of additional finance training.

There's been a lot of talk about double inheritors recently. These are often women

EXECUTIVE SUMMARY

- **Changing tax rates, especially the new 3.8% net investment income tax and the new 39.6% tax bracket,** create one of the most important issues for personal financial planners right now. The changes are prompting personal financial planners to create new tax-efficient investing strategies and to put together multiyear plans to smooth out income.
- **Succession planning is a major challenge for many firms.** The impending retirement of Baby Boomers may result in a wave of consolidation because bigger firms are going to be the only ones able to buy out some of the retiring practitioners.
- **For the first time, the AICPA is rolling out a new set of standards for personal financial planners.** This initiative will codify common-sense practices in the profession.

Chris Baysden is a JofA senior editor. To comment on this article or to suggest an idea for another article, contact him at cbaysden @aicpa.org or 919-402-4077.

who inherited money both from deceased parents and spouses. What are the best practices that you are seeing on reaching those clients and meeting their needs?

Sprinkle: I think it gets back to listening and being able to communicate to your clients. I think CPAs are very analytical, and we're very good with the numbers, but we're terrible at understanding the client's true needs and what's really bothering them. I think where we fall short in a lot of instances is the listening skills, the soft skills, and the understanding skills, the counseling skills. That's what keeps a client, and that's what clients are really looking for, and your people skills are what really differentiate you from your competitors.

The PFP Section is working on a new set of standards that will be rolled out soon. How will those standards impact personal financial planners?

Blackman: I think that the impact on CPAs in general is going to be very positive … all these years—we've had a specialty designation, and yet without standards—I believe [financial planning] has been considered something that CPAs do on a part-time basis. This is a watershed event for us, especially those of us that are CPAs and have been practicing full time as financial planners. The standards themselves … they really don't require much more than what a reasonable, conscientious CPA planner would be doing in the first place. It's essentially codifying common-sense practices. (For more detail on the standards, see "From *The Tax Adviser*: Proposed Statement on Standards in Personal Financial Planning," *JofA*, June 2013, page 82.) ❖

AICPA RESOURCES

JofA articles

- "Making a 'Backdoor' Roth IRA Contribution," April 2013, page 72
- "Tax Matters: Individual Health Care Mandate Rules Proposed," April 2013, page 74
- "Tax Cliff Averted," Feb. 2013, page 46
- "A Wealth of Opportunity," April 2012, page 22

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CPE self-study

- The 2013 Cumulative Tax Guide (#PTX1303D, online access)
- Tax Planning After the Healthcare Surtax: Tools, Tips, and Tactics (#PTX1302M, online access)

Conferences

- Advanced Estate Planning Conference, July 15–17, Baltimore
- Sophisticated Tax Planning for Your Wealthy Clients, Nov. 18–19, Boston
- Implementing Personal Financial Planning Services: Step by Step Plans for Success, Jan. 18–19, Las Vegas
- Advanced PFP Conference, Jan. 20–22, Las Vegas

Websites

- CPA/PFS education program, to gain competency in related subject matter, aicpa.org/PFS
- Forefield Advisor, to find client-friendly materials to navigate health care reform, aicpa.org/PFP
- PCPS Health Care Reform Toolkit, tinyurl.com/oa63rk6
- PFP Section Practice Center for practice support, aicpa.org/PFP/practicecenter
- PFP Section toolkit to help practitioners work through the implications of the American Taxpayer Relief Act and 3.8% Medicare surtax, aicpa.org/PFP/proactiveplanning
- PCPS Succession Planning Resource Center, tinyurl.com/cx2nauz

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Managing Change, People, and Transparency

An interview with former FASB chairman Robert Herz

by Ken Tysiac

Robert Herz, CPA, was FASB chairman from 2002 through 2010. Before joining FASB, he worked 28 years in public accounting with PwC and Coopers & Lybrand. His memoir, *Accounting Changes: Chronicles of Convergence, Crisis, and Complexity in Financial Reporting*, was published this spring. He also is co-author of *The Value Reporting Revolution: Moving Beyond the Earnings Game.*

In a memoir published this spring, former FASB Chairman Robert Herz, CPA, provides an insider's view of many of the important developments in accounting over the past 15 years. *Accounting Changes: Chronicles of Convergence, Crisis, and Complexity in Financial Reporting* describes Herz's background and almost 40 years in the accounting profession, his experiences during the financial crisis and international convergence efforts, and his ideas for the future. In a recent interview with the *JofA*, he discussed his views on change management, leadership, convergence, and complexity. Here are excerpts from the interview:

Your book describes a lot of the changes you and your colleagues made at FASB. During your tenure, FASB became the one standard setter, and the Accounting Standards Codification project was completed. You also made significant progress improving the outreach and transparency related

ILLUSTRATION BY JAMES STEINBERG/THEISPOT

to FASB's operations. Do you have a few guiding principles that you believe drive successful change management?

Herz: I would say it's a collective effort. We had a number of successes, and we had some areas where we weren't as successful, and I'll take responsibility for some of those where I may have misjudged things. With the benefit of hindsight, and as I touch upon in the book, I might have done some of those differently. But I think, first of all, the environment around you matters a lot. When I came to the FASB, it was on the heels of Enron, WorldCom, and a whole spotlight on the financial reporting system, including accounting standards, so there was a case for change. That presented a challenge, but I also thought it presented a great opportunity. I had a lot of ideas, and talking through them with my colleagues at the FASB, we refined those ideas, added some new ones, and then from the ideas you develop some actions.

It's important, though, that you have to make the case for changes. What's the existing issue? Why would the change you are suggesting make the world better?

Then, human beings, as we are, need time to absorb the change. So you need timelines. And you need good communication throughout the change management process. It's important to get buy-in both internally within the organization, and very importantly, to be able to make the case externally to those who will be affected by the change. There are always going to be some people who agree with a proposed change and some people who don't, but if you get enough of the stakeholders to agree that it seems to make sense, you're going to be much better off.

> "You have to make the case for changes. What's the existing issue? Why would the change you are suggesting make the world better?"—Robert Herz

What, in your opinion, is the secret to managing people successfully?

Herz: To me, leading and managing groups is about one L word and then lots of C words. The L word is "leadership." You do have to have confidence in yourself as a leader to gain the confidence of those you deal with. And I find there are a lot of C words that help you do that.

There's "collegiality." I've been fortunate to largely be able to work with—and I use the word frequently—colleagues. Great colleagues, people who work with you and try to help and pull toward the common mission. It's about "communication," and in that communication, it's about being "candid" and being "clear." And it's two-way communication: "Here's what I'm thinking. What are you thinking? How can we make this better?"

And I think it's just generally about "common sense" in the way you deal with people. You have to have some leadership, and you have to have a vision, but you can't just operate in a command-and-control manner.

Transparency, which you worked to improve at FASB, is a big issue today. Everybody wants to be as open as possible, and yet there are some things people don't want to share, too. Do you have any advice for leaders of businesses who struggle with how much to reveal and how much not to reveal?

Herz: I believe they've got to regard financial reporting and their whole corporate reporting as not just compliance, but really as an exercise in communication. And in that communication, you've got to convey to the audience what you think is important and what you think they need to know and understand.

I always was a fan of Warren Buffett's approach to his annual letter to shareholders. He said he writes as if he was a 50-50 partner, and his other partner has been away abroad for the whole year, and he has come back, and, "I really need to tell him what went on this year and where we stand." I really like that approach.

Now in public reports, obviously there are some things that are confidential. There are trade secrets and the like. I still think you can communicate without specifically getting into those areas. I also think the

EXECUTIVE SUMMARY

- **Former FASB Chairman Robert Herz has authored a new book,** *Accounting Changes: Chronicles of Convergence, Crisis, and Complexity in Financial Reporting.* In this interview, Herz discusses his views on change management, leadership, convergence, and complexity.
- **The environment around you matters a lot when you are making the case for change,** according to Herz. Good ideas and communication, as well as buy-in internally and externally, help make change successful, he said.
- **Leading and managing groups requires confidence** as well as some other important C words, Herz said. These include "collegiality," "communication" that is clear and candid, and "common sense."
- **Many people support the idea of common, high-quality financial reporting across the major world capital markets.** In the United States, though, the SEC should provide more clarity as soon as possible with respect to whether, when, and how IFRS will be incorporated into reporting by U.S. issuers, Herz said.
- **Regulators need to proceed with care to combat growing complexity,** according to Herz. Regulators need to make sure they create rules that make sense, are cost beneficial, and provide ample time for proper implementation, he said.

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framework for integrated reporting, which is like the enhanced business reporting framework that the AICPA was a part of, is a good framework for thinking about how to communicate the financial information and put it in the context of the whole business and your strategy. What's your business model? How do you create value over time, and what are the risks and opportunities? All of those are important things to be able to communicate clearly.

Convergence is a major theme of your book, and momentum for IFRS to be allowed or adopted for U.S. public companies seems to be waning, at least at the moment. Is there something that you believe can help generate more momentum for IFRS in the United States?

Herz: I think first, many, not all, people seem to support the goal of having common, high-quality financial reporting across the major capital markets of the world. And I think having a single set of standards or at least highly comparable standards is an important part of getting to that end result.

I also think people will acknowledge that IFRS has become widely used around the world, and accepted in many parts of the world as the international standard. I think as far as the U.S. goes, there are various perceived issues. Our standards, while capable of improvement, are pretty good. And our reporting system is felt to be pretty good, maybe the best in the world.

In the convergence effort, we've brought the standards closer together, but as I describe in the book, there are still a lot of differences. Therefore, a wholesale, "Big Bang" change to IFRS could entail significant costs by companies and other parties in the system. And then there's the issue of sovereignty and politics, and the FASB being regarded as the U.S. standard setter and closer to its U.S. constituents. And there are some concerns that from time to time the IASB (International Accounting Standards Board) may be influenced by some other parties whose goals might not be the same as ours in the U.S.

While not dismissing these concerns, I continue to strongly support trying to get to the end goal of common, high-quality financial reporting across the global capital markets. With regard to where the U.S. goes in terms of IFRS, the ball lies mainly in the SEC's court. They can get a lot of help from the FASB and the FAF (Financial Accounting Foundation), but the decision on whether, when, and how to incorporate IFRS into reporting by U.S. issuers ultimately rests with the SEC. For a number of years, the SEC said—and people expected—that decision would be made in 2011. That didn't happen, and it is not clear now when or even whether the SEC will come to a decision on this matter. And so in light of this, I think it is understandable that some people in the United States have begun to lose interest in this subject. But as I discuss in the book, I believe this is still a very important issue, both to the United States and around the world, and while I certainly understand the SEC has lots of other important priorities, I would continue to encourage them to provide more clarity on this subject as soon as possible.

> "It's up to the regulators ... to make sure ... that the new regulations they're proposing make sense, that they're cost beneficial ..."—Robert Herz

Complexity is another theme of your book. Standards and regulation overload is a huge theme for businesses right now. You write in your book that in the wake of the financial crisis, just about all the parties have more issues to deal with than standards overload. But regulation seemingly is increasing at an exponential rate, and I'm wondering how we can avoid reaching a breaking point.

Herz: I think very understandably people are saying, "Gee, in terms of new accounting standards, you need to understand that there are a lot of other things we have to deal with right now." Particularly for some industries, such as financial services, there are all the regulations emanating from the Dodd-Frank Act and other acts. So the fact that they have to deal with those new regulations means that they may have less time and resources to be able to deal with new accounting standards.

I think whether it's accounting standards or new regulations, again, it's a matter of whether or not there's really a case or a need for the change. What is going to be the benefit, the cost/benefit? I happen to think in terms of some of the regulations around the financial markets and the financial services industry, there was a need for some real changes in the wake of the financial crisis. But then it's up to the regulators through a very good process to make sure they get good input, make sure they consider that input, that the new regulations they're proposing make sense, that they're cost beneficial, and that there is sufficient lead time for people to implement them in an orderly way. ❖

AICPA RESOURCES

JofA **articles**

- "Still in Flux: Future of IFRS in U.S. Remains Unclear After SEC Report," Sept. 2012, page 28
- "125 People of Impact in Accounting," June 2012, page 58
- "Change Agent," Feb. 2008, page 30

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Global Mobility

U.S. CPA credentials travel around the world.

by Sabine Vollmer

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Within the continental United States, CPAs are fairly mobile. No matter in which state they are based, they are generally able to temporarily practice across state lines without obtaining a reciprocal license if they have 150 hours of education, passed the CPA exam, and have at least one year of experience. The only remaining U.S. jurisdictions without an individual CPA mobility law are Hawaii, Guam, Puerto Rico, the Virgin Islands, and the Northern Mariana Islands. The rules for foreign countries are different, but U.S. CPAs interested in working abroad will find six nations open and hassle-free.

For U.S. CPAs, global mobility is largely determined by mutual recognition agreements (MRAs). MRAs are contracts between professional accounting organizations from countries that have signed the General Agreement on Trade in Services, a World Trade Organization treaty that took effect in 1995. To better understand why global mobility is gaining in importance and what MRAs can do for CPAs, the *JofA* talked to Jim Knafo, AICPA director–International Relations. From 1999 until 2012, Knafo helped negotiate existing U.S. MRAs as a volunteer member of the International Qualifications Appraisal Board (IQAB). The U.S. IQAB, whose members are appointed by the National Association of State Boards of Accountancy (NASBA) and the AICPA, reviews accounting qualifications in other countries, negotiates MRAs with foreign professional accounting organizations, and makes reciprocity recommendations to the AICPA, NASBA, and state boards of accountancy. The following are excerpts from the conversation with Knafo:

Why would U.S. CPAs explore licensure elsewhere?

Knafo: Global mobility is important for two reasons. The first is that the world is becoming a much smaller place, and our clients, even small ones, are turning to international markets more and more. We need global mobility in much the same way that we need interstate mobility: to continue to serve and grow with our clients. Similarly, more companies want to do business in the U.S. What better way to break the ice with a potential new client than to start the conversation by

MRA Requirements for U.S. CPAs

by Amanda M. Grossman, CPA, Ph.D., and Holly R. Rudolph, CPA, DBA

Beyond the borders of the United States, obtaining mobility has been eased by the establishment of mutual recognition agreements (MRAs) with professional accountancy bodies in six countries. This chart outlines the requirements for U.S. CPAs to work in these countries.

Jurisdiction	Agreement Participant	Education Requirements	Examination Requirements	Experience Requirements	Cost	Contact Information
Australia	Institute of Chartered Accountants in Australia (ICAA)	Same as U.S. jurisdiction granting certification, plus corporations law and taxation courses taken at an Australian university.	Same as U.S. jurisdiction granting certification.	Same as U.S. jurisdiction granting certification.	Tuition for corporations law and taxation courses, plus ICAA membership.	ICAA 33 Erskine St. Sydney, NSW service@charteredaccountants.com.au 61-2-9290-5660 (voice) 61-2-9262-4841 (fax) **charteredaccountants.com.au**
Canada	Chartered Professional Accountants of Canada (CPA Canada)	Same as U.S. jurisdiction granting certification in U.S. states following the Uniform Accountancy Act. More information: **www.becomeacaincanada.ca**	Must pass the Chartered Accountants Reciprocity Examination (CARE).	Minimum of three years. More information: **www.catrainingoffice.ca**	Exam fees differ among provinces. Average exam fee: CAD$950 ($945). Plus CPA Canada membership.	CPA Canada 277 Wellington St. West Toronto, ON M5U 3H2 Canada 416-977-3222 (voice) 416-977-8585 (fax)

(Continued on next page)

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Jurisdiction	Agreement Participant	Education Requirements	Examination Requirements	Experience Requirements	Cost	Contact Information
Hong Kong	Hong Kong Institute of Certified Public Accountants (HKICPA)	Baccalaureate degree or baccalaureate and higher degree, including an aggregate of at least 150 semester hours substantially undertaken in the United States.	HKICPA aptitude tests on Hong Kong law and taxation.	At least three years of relevant accounting experience recognized by the HKICPA; additional requirements for Practising Certificate (to perform statutory audits in Hong Kong).	HK$1,000 ($130) per aptitude test, plus HKICPA membership.	HKICPA 37/F, Wu Chung House 213 Queen's Road East, Wanchai, Hong Kong hkicpa@hkicpa.org.hk 852-2287-7228 (voice) 852-2865-6603 (fax) hkicpa.org.hk/en
Ireland	Chartered Accountants Ireland (CAI)	Same as U.S. jurisdiction granting certification.	Must pass examination on taxation and law for accountants.	Minimum of two years to gain practice rights. Additional experience is required for audit practice rights.	€264 ($350) for exams, plus CAI membership.	CAI Chartered Accountants House Pearse Street Dublin 2 Co. Dublin, Ireland info@charteredaccountants.ie 353-1-637-7200 (voice) www.charteredaccountants.ie
Mexico	Instituto Mexicano de Contadores Públicos (IMCP)	Same as U.S. jurisdiction granting certification.	Must pass the MEXQEX (in Spanish).	Same as U.S. jurisdiction granting certification.	About $360 in certification fees, plus IMCP membership.	IMCP Bosque de Tabachines 44 Bosques de Las Lomas Cuajimalpa de Morelos 11700 Mexico City, DF, Mexico 52-55-5267-6400 (voice) imcp.org.mx
New Zealand	The New Zealand Institute of Chartered Accountants (NZICA)	Same as U.S. jurisdiction granting certification, plus taxation, commercial, and corporate law courses taken at a New Zealand tertiary education provider.	Same as U.S. jurisdiction granting certification.	Same as U.S. jurisdiction granting certification. (Practice Certificate experience waived for documented equivalent U.S. experience).	NZ$550 ($478) for assessment of overseas study, plus NZICA membership.	NZICA Level 7, Tower Building, 50 Customhouse Quay, PO Box 11342, Wellington 6142, New Zealand customer@nzica.com 64-4-474-7840 (voice) 64-4-473-6303 (fax) nzica.com

***Amanda M. Grossman** (agrossman@murraystate.edu) is an associate professor of accounting, and **Holly R. Rudolph** (hrudolph@murraystate.edu) is a professor of accounting, both at Murray State University in Murray, Ky.*

Sources: Institute of Chartered Accountants in Australia; Chartered Professional Accountants of Canada; Hong Kong Institute of Certified Public Accountants; Chartered Accountants Ireland; Instituto Mexicano de Contadores Públicos; and The New Zealand Institute of Chartered Accountants.

mentioning that you have an accounting designation from their home country? Right away, that gives you an edge over the next accountant who is pursuing the client.

The second reason is more personal. Global mobility gives you the opportunity to live and work abroad for a few years, broaden your professional expertise, and gain new perspectives without having to put your career progression on hold.

What does an MRA do for a CPA, and which countries have MRAs with the United States?

Knafo: The MRAs negotiated by the IQAB allow U.S. CPAs to access licensure in foreign countries through an accelerated route. An MRA is essentially a shortcut. It allows professionals who have already been tested and certified in their home country to move to another country without having to start over. They don't have to meet additional education requirements or take other countries' equivalent of the U.S. Uniform CPA Exam. The MRA allows professionals to have their existing credential, and all that went into earning it, recognized. Generally, the sole requirement to obtain the foreign license is to pass a short exam on local laws, tax, and regulations.

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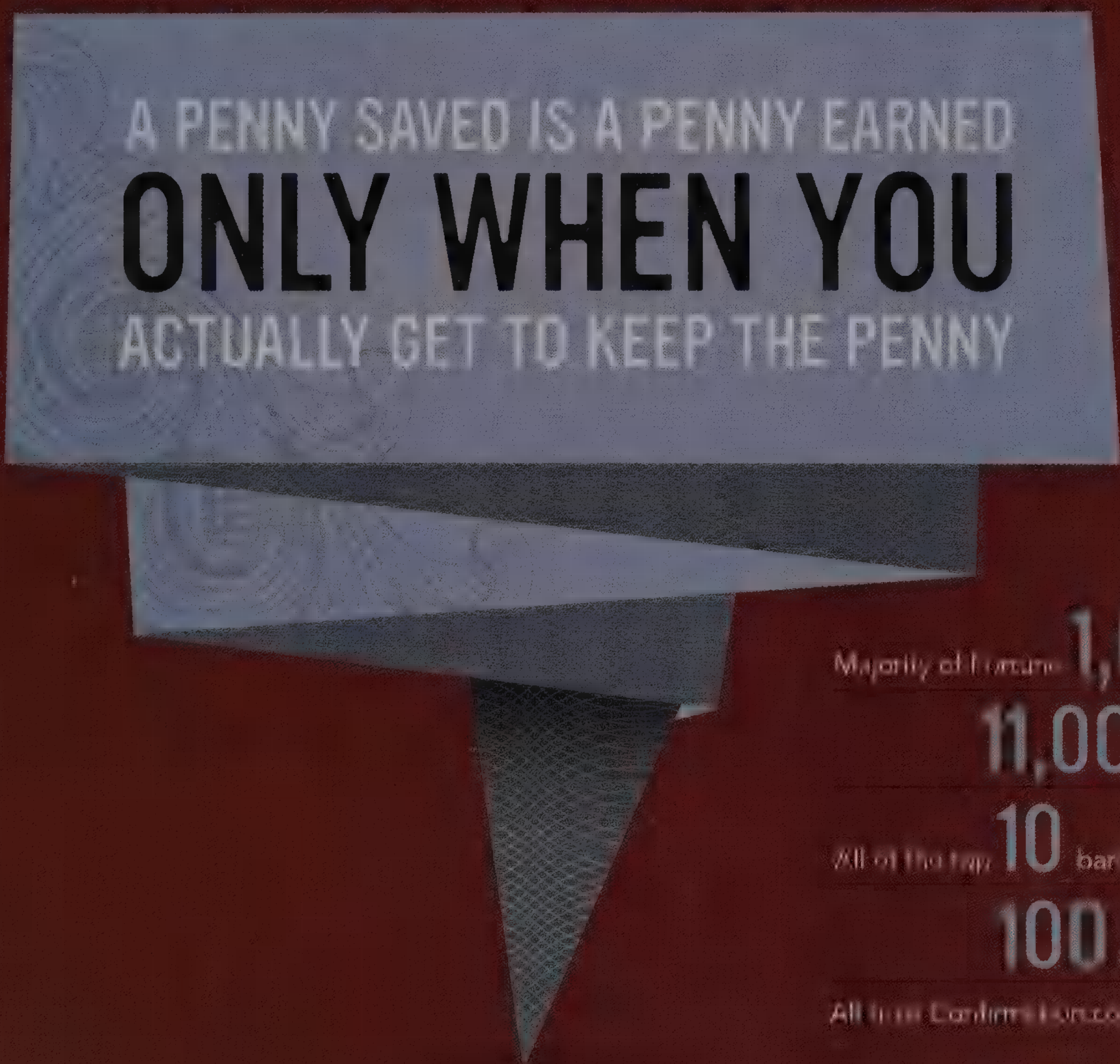

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The National Association of State Boards of Accountancy and the AICPA currently have MRAs with professional accounting organizations, or PAOs, in Canada, Mexico, Australia, New Zealand, Ireland, and Hong Kong (see sidebar, "MRA Requirements for U.S. CPAs"). With an MRA, individual U.S. CPAs do not have to be evaluated on a case-by-case basis, because, in essence, the U.S. CPA certification process has already been prescreened by the foreign PAO.

> "We need global mobility in much the same way that we need interstate mobility: to continue to serve and grow with our clients."—Jim Knafo

What options do U.S. CPAs have in countries that do not have MRAs with the United States?

Knafo: In some non-MRA countries, a U.S. CPA seeking licensure may get lucky, because due to the outstanding reputation of the U.S. CPA certification and the AICPA around the world, some foreign PAOs may recognize and give credit for the CPA's U.S. education and/or experience.

But usually U.S. CPAs will have to meet the same qualification requirements as local candidates without the MRA shortcut. This may mean additional education, local experience, or one or more examinations. Some countries even require residency or citizenship. To find out more, I suggest that U.S. CPAs interested in working in a non-MRA country visit the website of and contact the country's PAO.

Do U.S. CPAs who are licensed elsewhere have a competitive advantage?

Knafo: Think of this question from the opposite perspective. If a foreign accountant came to the U.S., would she have an advantage if she became a U.S. CPA? Of course. Without a U.S. CPA would she be able to practice in the U.S.? Would her chances of getting a job improve if she obtained her U.S. CPA?

The same rationale holds true for a U.S. CPA who moves abroad, wants to attract foreign clients, or wants to retain clients who are expanding internationally. ❖

***Sabine Vollmer** is a JofA senior editor. To comment on this article or to suggest an idea for another article, contact her at svollmer@aicpa.org or 919-402-2304.*

AICPA RESOURCES

JofA articles

- "How to Do Business in India," March 2013, page 26
- "Business Basics in Brazil," Nov. 2011, page 34
- "Business Basics in China," May 2011, page 42

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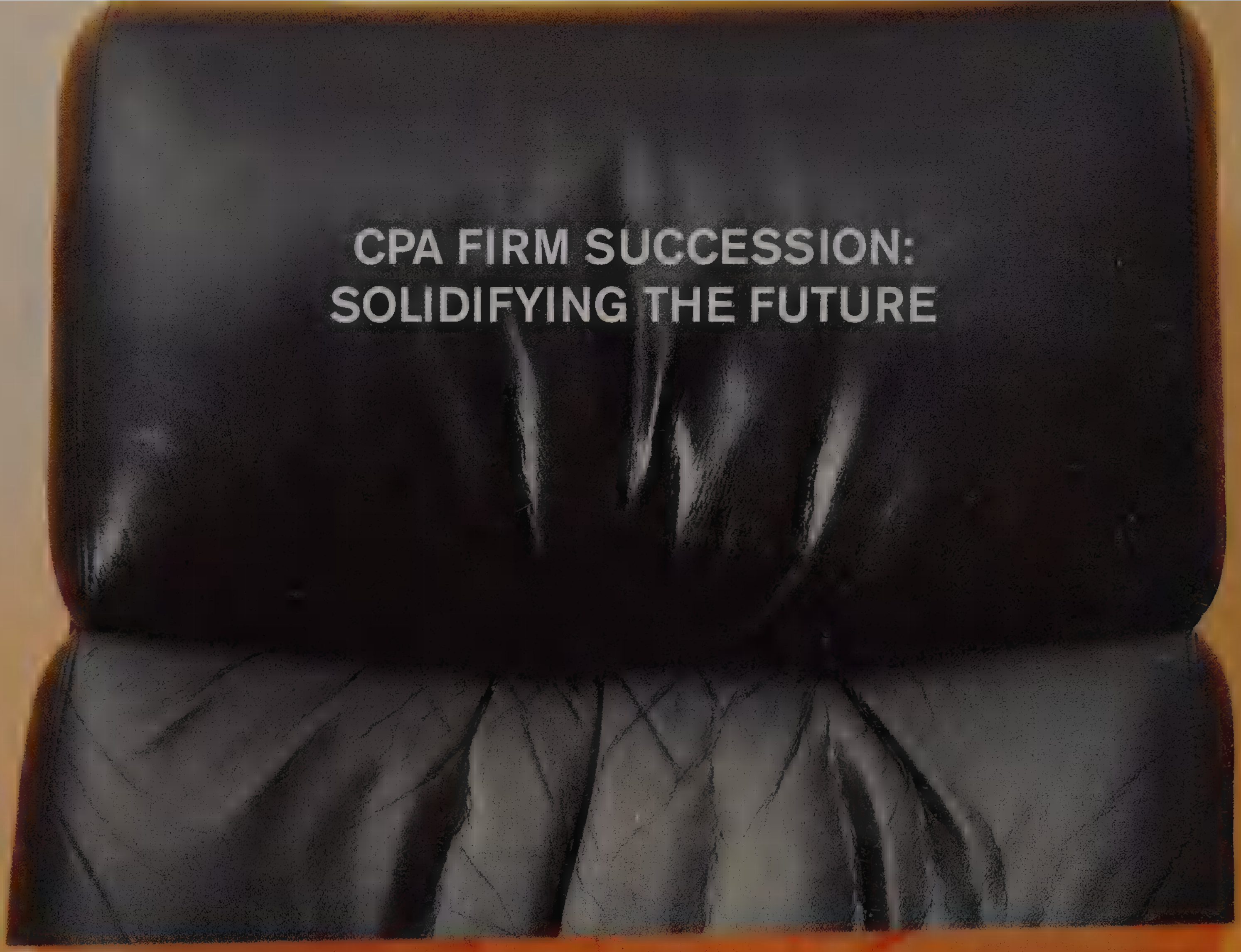

Mergers Emerge as Dominant Trend

First in a series: New demographic and economic realities are reshaping succession strategies.

by Joel Sinkin and Terrence Putney, CPA

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Powerful forces are transforming the accounting profession in the United States. The Baby Boomers are heading into their retirement years. Baby Boomer CPAs are in charge of most U.S. accounting firms. And most U.S. accounting firms don't have a signed succession or practice-continuation plan in place.

These realities are rewriting the rules for U.S. accounting firms and CPA firm owners. Gone are the halcyon days of whipping together a succession strategy, transitioning the clients to the next generation of CPAs, and riding off into a retirement funded by the new partners at the firm. Firms today must contend with unprecedented financial, cultural, and marketplace changes.

To help CPAs deal with these changes, the *JofA* is presenting a succession series designed to help accountants navigate the new landscape of succession and mergers. This installment examines the importance of understanding the mergers-and-acquisitions (M&A) market when preparing a succession plan.

The M&A Factor

M&A has emerged as a dominant trend among U.S. accounting firms. Dozens of major mergers have been announced over the past three years, and scores more have taken place under the radar. How prevalent is the merger mania? Nearly half of all U.S. accounting firms either were in merger talks or expected to be within two years, according to the *2012 PCPS Succession Survey*.

Demographics and other succession issues are the main factors fueling the consolidation craze. The gap between the number of firms dealing with partner retirements and the number of firms with successors, or even succession plans, in place has created a need to find alternative ways to continue the practice and fund partner retirements. Increasingly, firms are looking to the merger markets for an exit. This trend is affecting the balance between a "buyer's market" and a "seller's market" and having an impact on firm valuations as well.

Despite all the turmoil, a firm's size and location continue to be the main factors in determining its appeal, and value, to potential buyers. For instance, small firms in densely populated areas are operating in a seller's market. A plethora of firms with the capacity to buy smaller competitors gives selling firms a number of options when seeking a suitor.

The market also favors the selling firm because many midsize firms can absorb small firms with little to no incremental increases in overhead, especially if the selling firm isn't locked into long-term, expensive leases. That makes an acquisition a cost-effective means of growth. Buying firms, thus, are willing to pay higher prices to acquire smaller operations because it's still cheaper and easier than growing by adding one client at a time or adding a service niche to create cross-selling opportunities and attract new clients.

> Firms with excellent niches, strong young talent, or a strong and growing client base can separate themselves from the competition, driving up their value.

In contrast, small firms in remote areas remain stuck, and are likely always to be stuck, in a buyer's market. The limited supply of potential buyers means that it's difficult for a selling firm to find a suitor. In some areas, accounting firms don't feel pressure to acquire a retiring competitor's clients because most of those clients "have no one else to go to anyway."

Where the most significant change in the buyer-seller balance has occurred is among small-to-midsize regional firms. Consider the following: In a large metro area such as Boston, there are dozens of firms generating between $3 million and $8 million in annual revenue and a handful of larger regional firms—those with

EXECUTIVE SUMMARY

- **Mergers and acquisitions (M&As) are becoming increasingly popular as an exit strategy for retiring CPA firm partners.** New demographic and economic realities are making it more difficult for firms to complete internal succession, leaving a sale to an outside firm as the best option.
- **Increased M&A activity among accounting firms is affecting, in some areas, the balance between a "seller's market" and a "buyer's market."** The biggest change is being seen among small-to-midsize regional firms.
- **The rising number of CPA firms up for sale is exerting downward pricing pressure on firm values.** This means that time is of the essence for CPAs to figure out how they are going to pay for their retirement and whether an external sale will be necessary.
- **Buyers are requiring longer partner-retention periods in accounting firm acquisitions** and are putting down less money upfront.

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To comment on this article or to suggest an idea for another article, contact Jeff Drew, senior editor, at jdrew@aicpa.org or 919-402-4056.

$20 million or more in annual revenue. The smaller firms represent good acquisition targets for the bigger firms, for the reasons already discussed, but until recently relatively few of the smaller firms have come on the market because their business has been solid and they've executed internal succession to pay for partner retirements. That pattern, however, is changing.

> A firm's size and location continue to be the main factors in determining its appeal, and value, to potential buyers.

Downward Pressure and Other Trends

An increasing number of smaller regional firms are discovering (or will discover in the near future) that they don't have the cash flow or young talent to execute an internal succession plan. The firms then have little choice but to seek an exit via merger or acquisition. This trend is producing a larger supply of smaller regional firms, shifting the power in the marketplace to the buyers and creating downward pressure on firm valuations.

The authors have already seen values of firms drop over the past few years for both internal valuations (partners buying out partners) and external sales. Also, buying firms are putting less money down on acquisitions and are placing a stronger emphasis on retention periods for partners with the smaller firms, which tend to have partner-loyal client bases. All of these trends will continue, with some exceptions. Firms with excellent niches, strong young talent, or a strong and growing client base can separate themselves from the competition, driving up their value.

What does this all mean for firms that have yet to complete their succession plan? When should a firm have a plan in place? Those questions will be addressed in next month's installment of this series. ❖

AICPA RESOURCES

JofA articles

- "Succession Planning: The Challenge of What's Next," Jan. 2013, page 44
- "Planning and Paying for Partner Retirements," April 2012, page 28
- "Traps for the Unwary in CPA Firm Mergers and Acquisitions," Aug. 2011, page 36
- "Accounting Firm M&As: A Market Update," Nov. 2010, page 30
- "Mergers & Acquisitions of CPA Firms," March 2009, page 58, and "Keeping It Together: Plan the Transition to Retain Staff and Clients," April 2009, page 24 (two-part article)

Use journalofaccountancy.com to find past articles. In the search box, click "Open Advanced Search" and then search by title.

Publication

- *Management of an Accounting Practice Handbook* (#090407)

CPE self-study

- Making Key Financial Decisions: Practical Tools and Techniques for Making Your Key Financial Decisions (#733835)
- Mergers, Acquisitions and Sales of Closely Held Businesses: Advanced Case Analysis (#732867)

Conferences

- E.D.G.E.–Sharpening the Next Generation of CPAs, Aug. 7–9, Austin, Texas
- AICPA Succession Planning Summit–Oct. 28–29 for midsize firms; Oct. 29–30 for large firms; Oct. 31 for sole practitioners and small firms; New York City and Durham, N.C.

For more information or to make a purchase or register, go to cpa2biz.com or call the Institute at 888-777-7077.

Survey reports

- *2012 PCPS Succession Survey* (sole proprietors), tinyurl.com/ptyegnk; and *2012 PCPS Succession Survey* (multiowner firms), tinyurl.com/qzhabug

Private Companies Practice Section and Succession Planning Resource Center

The Private Companies Practice Section (PCPS) is a voluntary firm membership section for CPAs that provides member firms with targeted practice management tools and resources, including the Succession Planning Resource Center, as well as a strong, collective voice within the CPA profession. Visit the PCPS Firm Practice Center at aicpa.org/PCPS and the Succession Planning Resource Center at tinyurl.com/oak3l4e.

The Succession Situation

Succession is a major issue not being dealt with on an adequate level within the CPA profession. Consider the following findings from the *2012 PCPS Succession Survey*, a joint project of the AICPA Private Companies Practice Section (PCPS) and Succession Institute LLC:

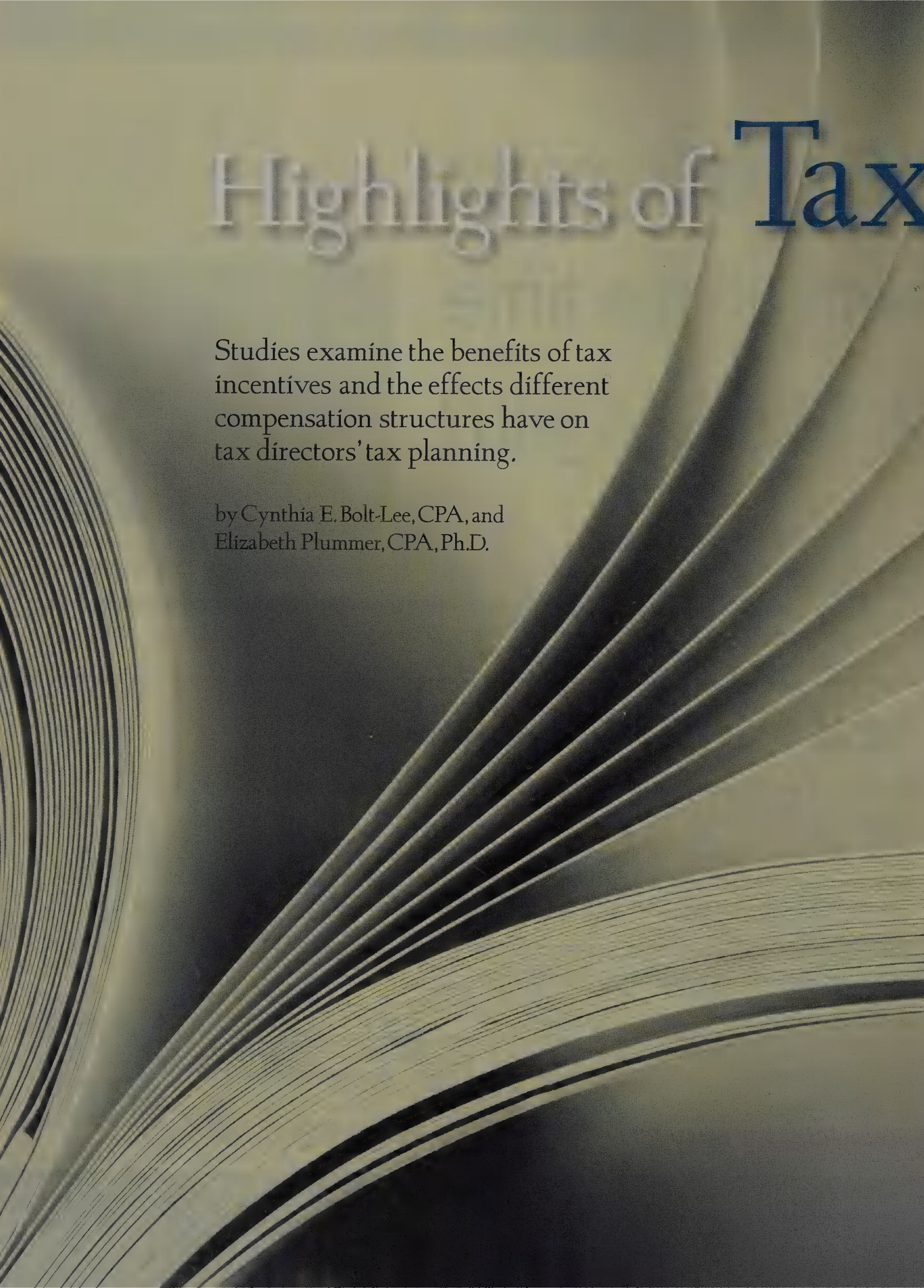
- Nearly 80% of the CPA firm owners surveyed expected succession to become a major issue for their firms in the next 10 years.
- Fewer than half of all multi-owner accounting firms had a written and signed succession plan. The percentages dropped dramatically for smaller firms: 33% for firms with eight to 15 professionals, 25% for firms with three to seven professionals, and 14% for firms with one or two professionals.
- Only 6% of sole proprietorships had practice continuation agreements (PCAs), the first step in succession planning.

For more, see the *JofA* article "Succession Planning: The Challenge of What's Next" (Jan. 2013, page 44).

Highlights of Tax

Studies examine the benefits of tax incentives and the effects different compensation structures have on tax directors' tax planning.

by Cynthia E. Bolt-Lee, CPA, and Elizabeth Plummer, CPA, Ph.D.



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Research

With tax reform in the news, it is helpful to understand the origins of some popular and long-lived tax incentives, such as the favorable tax treatment of people over 65 and tax incentives that encourage people to save. As the economy takes fitful steps to recover, insight into the efficacy of property tax incentives offered by states and municipalities to attract businesses to their jurisdictions is also timely. A final study examines the relationship between a tax director's compensation structure and the level of tax planning handled in that position. This article examines recent research on these topics in prominent accounting and tax research journals.

Income Tax Breaks for Seniors: A Legislative History

Tax breaks for seniors have been around since the 1940s. As the Baby Boomers enter retirement age, this popular tax policy will continue to have a widespread and material effect on federal and state budget deficits. "The Genesis of Senior Income Tax Breaks," published in the December 2012 *National Tax Journal*, investigates the origin of state and federal tax laws to determine how tax breaks for retirement-age individuals ended up where they are today.

Authors Karen Conway and Jonathan Rork analyze two main income tax breaks: (1) tax exemptions, deductions, or credits based on a taxpayer's age and (2) exemptions or exclusions for pension and retirement income. Results of the study reveal that these two categories of tax breaks began in very different ways and that, interestingly, neither occurred as a result of political pressure or election strategy.

In 1948, Congress began providing age-related exemptions for individuals 65 or over, arguing that seniors who experienced low income were also unable to find work to help with the increasing cost of living. In an effort to gain President Harry Truman's approval for the age-related exemption, the general personal exemption and the exemption for the blind, both of which existed at the time of the proposal, were increased as well. The opposing minority view held that the high cost of living equally affected younger, low-income individuals and that tax breaks for people over 65 would be inequitable. However, the increase in the general exemption from \$500 to \$600 was popular among voters and paved the way for the passage of the law. As an additional incentive for passage, those in favor of the \$600 old-age exemption argued that failure to increase Social Security benefits to meet post-World War II cost-of-living increases created a hardship for the elderly.

Passage of the federal age-based exemption caused a ripple effect in states' tax laws, with Vermont becoming the first state to offer the exemption. By 1980, more than 90% of the states had some type of tax break based on advanced taxpayer age.

The taxability of retirement income was an issue addressed separately from the age-based exemption. When Social Security was enacted in 1935, federal law did not address its taxability, but by 1941, the federal government officially acknowledged the exclusion of Social Security benefits from taxable income in an office ruling.

This ruling, from the Bureau of Internal Revenue (the IRS's predecessor), appears to have "accidentally" created the exclusion of Social Security benefits. As the federal tax break became official, many states followed, but not without concern about the loss of revenue.

While the federal government has always taxed non-Social Security retirement income, the states chose a different path. The first state tax break for pension income occurred, once again, in Vermont in 1931, and, once again, appeared to have occurred by oversight. However, the Vermont pension exemption was short-lived and was soon replaced by an old-age exemption in 1947.

A few states followed, mostly by failing to include non-Social Security pension income in their tax base when laws were originally written. By the early 1970s, pension exclusions from state taxable income became more widespread. These tax breaks appear to have been a response to Social Security amendments signed by President Richard Nixon in 1972, which transferred most of the responsibility for elderly health care and retirement needs to the federal government from the states. Not needing to spend revenue on the elderly made the older population more attractive to the states, which enacted tax breaks to entice them to move.

As more states exempted pension income, competition between states appeared to be a strong factor in the increasing number of states adopting the exemption. Neither the size of each state's population nor the size of its elderly population appeared to have an effect on whether a state adopted the exemption. Instead, the states appeared to be overtly as well as covertly competing for the elderly to live in their states, justifying the tax breaks because the elderly did not use public services.

Research reveals that at higher income levels, the elderly typically pay almost 50% less in state income taxes than other taxpayers. As the population continues to age, that disparity will have a growing effect on state budgets. Knowing how these tax laws originated provides useful information as the debate continues about the effectiveness and efficiency of these exemptions and other tax breaks. This research, funded by the National Institutes of Health, fills the gaps in understanding the evolution of senior income tax breaks.

How Tax Changes Affect Tax-Preferred Savings

Do taxpayers respond to changes in tax laws that affect retirement plans by participating more frequently or increasing the size of contributions to their tax-preferred savings accounts? No doubt tax policies play a large role in the volume of contributions to these retirement plans, but to what extent?

Assets in defined contribution plans (e.g., 401(k)s) in the late 2000s totaled almost $8.5 trillion, more than three times larger than the amount held in defined benefit plans (e.g., employer-funded pension plans). This study, "The Effect of Recent Tax Changes on Tax-Preferred Saving Behavior," (*National Tax Journal*, June 2012) examines the changes that occur to defined contribution plans—in participation rates as well as contribution size—when tax policies change. The research additionally measures the reduction in tax revenue from increased taxpayer contributions. Those findings help determine the effectiveness of changes in tax law on increasing retirement savings as well as the effect on tax revenue.

A study suggests that changes in tax policy have a limited effect on retirement account savings. Taxpayers open accounts but don't tend to increase contributions.

For this research, authors Bradley Heim and Ithai Lurie examined data from the IRS's Statistics of Income (SOI) Program for the years 1999–2005. The SOI program provides taxpayer data obtained from information reports and tax returns. The data include items such as contributions to IRAs and 401(k)s and taxpayer income and adjusted gross income (AGI).

The authors analyzed data from more than 190,000 tax returns to determine taxpayers' responses to changes in the after-tax cost of contributing to a tax-preferred plan. More than 92,000 contributions were in the returns analyzed.

During the period studied, two major changes in tax policy affected tax-preferred savings accounts. The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), P.L. 107-16, created the saver's credit, a nonrefundable credit for retirement account contributions. EGTRRA also increased the earned income tax credit for those making pretax contributions to their employer-based retirement plans. The Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA), P.L. 108-27, reduced marginal tax rates, making tax-preferred savings plans less attractive than during periods with higher marginal tax rates, but alternatively providing taxpayers with higher after-tax income. Prior research has shown that higher after-tax income results in greater savings overall, which would potentially make a tax-preferred savings account more attractive. Tax law changes before EGTRRA and JGTRRA also affected the period examined.

The authors' analysis reveals that these changes had a statistically significant effect on the number of taxpayers contributing to tax-preferred retirement accounts. More people contributed to retirement accounts, with lower-income taxpayers (income less than $50,000) more likely to begin contributing than higher-income taxpayers (income greater than $100,000). This effect appears to have been caused by a reduction in marginal tax rates (which increases after-tax income) and a decrease in the cost of contributing (due to the reduction in tax as a result of making

contributions). The dollar amount of these contributions, however, did not increase.

The authors suggest that changes in tax policy may motivate a taxpayer to open a retirement account, but once the account is opened with the minimum amount required for employer matching funds, the taxpayer does not tend to increase the contribution. Given the less-than-significant impact on savings revealed in the study, policymakers should reconsider using tax incentives to influence taxpayers' savings behavior.

Property Tax Incentives: Problems and Suggested Reforms

State and local governments spend $5 billion to $10 billion a year on property tax incentives to entice businesses to locate in their jurisdictions and to promote economic development. Although incentives can take different forms, common ones include property tax abatement programs, tax increment financing, enterprise zones, and incentives granted to specific companies. But how well do these incentives work? What are the problems? What can be done to improve their effectiveness? In their article, "Property Tax Incentive Pitfalls," published in the December 2012 issue of the *National Tax Journal*, authors Daphne Kenyon, Adam Langley, and Bethany Paquin use case studies on property tax incentives to highlight the incentives' problems and to suggest reforms.

The authors found that the biggest problem is providing property tax incentives to a company that would have located in the jurisdiction anyway, which means the government has reduced its tax revenues for no reason. The authors argue that property tax incentives are more likely to affect a company's location decision if property taxes are a significant component of a company's total costs and if the company serves a national or international market. The larger the company's market, the less likely the company is tied to a specific geographic area. Governments can make more effective use of property tax incentives if they focus them on companies that meet this description.

Another common error in property tax incentives occurs when the costs of the incentive exceed the benefits to the jurisdiction. Although attracting a company may result in desirable outcomes such as increased employment and population growth, how much will public service costs increase? Will the government be required to expand or improve the existing infrastructure, and at what cost? And while the new business may enhance the city's character and property values, are there significant environmental or congestion costs as well?

Assuming a property tax incentive creates new jobs, what proportion of the jobs will go to current residents versus commuters or new residents, and how much will the jobs pay? Attracting minimum wage jobs is less likely to provide a net benefit to the community. The government must also consider what effect the new business will have on existing businesses. Will the new company purchase goods and services from current businesses, or will it take customers away from them? Policymakers must undertake this type of comprehensive analysis to determine whether granting the incentive makes good sense for the community as a whole.

Rather than providing a tax reduction for a specific business, governments can also lower property tax rates and make their communities more attractive to businesses in general. The authors review studies on tax reductions that suggest that property tax differences within a metropolitan area do have a significant effect on where businesses choose to locate, with a 1% reduction in a jurisdiction's property taxes leading to a 1.59% to 1.95% increase in economic activity.

Evidence suggests that the economic benefits are temporary because neighboring jurisdictions often respond by lowering their tax rates, so in the end all jurisdictions have lower tax rates and no one gains a competitive advantage. For incentives to be effective, state and local policymakers must ensure that tax incentives are designed with a specific purpose (e.g., to attract a certain business or to aid an economically disadvantaged area).

The authors discuss how evaluating the effectiveness of property tax incentives is difficult because state and local governments provide little information about them, and when they do, little of the information is specific, such as which companies benefit and by how much. Evidence is rarely available on the actual response to the incentive, such as changes in employment or economic activity. Making government officials more accountable can help increase the effective use of property tax incentives. States such as Oregon and Minnesota have taken steps toward increasing transparency and evaluation.

The authors call on state and local governments to increase the information available on tax incentive programs, and to provide systematic and independent reviews of their effectiveness. Although there is ample evidence of the problems with property tax incentives, the authors remain optimistic about improving their use.

Tax Directors' Incentives for Tax Planning

Company tax directors are normally most directly responsible for advising management on how to structure transactions to reduce tax costs, as well as for making their companies' tax planning and tax strategy decisions. Their responsibilities range from lowering the company's cash tax burden to reducing the income tax expense reported on financial statements. Despite tax directors' importance, little is known about how tax directors are compensated because their compensation is generally not publicly available. Are tax directors' compensation packages structured so that they have incentives to make advantageous tax planning decisions?

In their paper, "Incentives for Tax Planning" in the *Journal of Accounting and Economics* (February–April 2012), authors Chris Armstrong, Jennifer Blouin, and David Larcker examine the annual compensation for tax directors employed by 423 companies from 2002 through 2006.

Their study examines proprietary data provided to them by a large human resources consulting firm that administers an annual survey and collects detailed compensation information for several executive positions, including tax directors. The data include the annual salary, bonus, restricted stock and option grants, and long-term incentive plans for each tax director. The authors' sample consists of very large companies, with a median market value of $9.2 billion and median taxable income of approximately $460 million. These companies therefore have significant tax liabilities, making them more likely to hire tax directors to pursue tax planning opportunities.

The tax directors in the sample are highly paid, with mean and median total compensation of $788,000 and $559,000, respectively. On average, tax directors' compensation consists of 41% fixed components such as salary, 45% equity components (e.g., stock options), and 14% bonus, meaning that, on average, 59% of the tax directors' compensation is performance-based. This suggests that tax directors' responsibilities extend beyond tax compliance to tax planning and strategy.

The authors use several types of statistical analyses to examine the relation between tax directors' incentive compensation and the level of a company's tax planning, using information contained in a company's financial statements. They choose to focus on two tax rate measures: the company's book tax rate (or effective tax rate) and the company's cash tax rate (the amount of cash a company pays for taxes during the year, divided by net income before taxes).

The authors find that tax director's compensation increases as the company's book tax rate decreases, suggesting that tax directors are provided with incentives to reduce the tax expense reported in a company's financial statements. In contrast, the authors find no evidence that tax director's incentive compensation varies with the company's cash tax rate.

Overall, the results suggest that tax directors have incentives to reduce the tax expense reported in the financial statements, but do not have incentives to affect the other measures of tax planning. This suggests that a company's book tax rate is a clearer signal of a tax director's efforts and results, making it a more desirable variable to include in a tax director's compensation contract. ❖

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AICPA RESOURCES

***JofA* article**

- "A Showcase of Tax Research," Oct. 2008, page 48

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Publication

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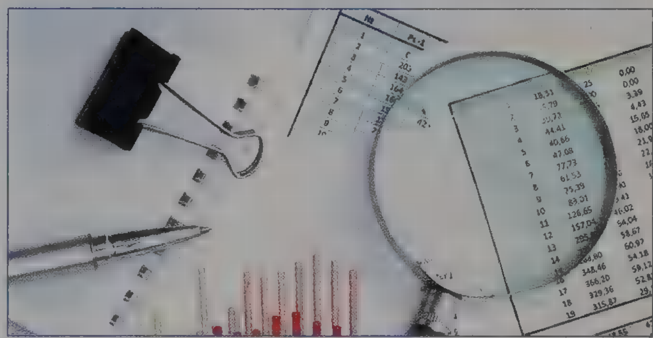

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TAX PRACTICE CORNER

Requesting a First-Time Abatement Penalty Waiver

The IRS's first-time abatement (FTA) penalty waiver, although introduced 12 years ago, remains little known and often unrequested by qualifying taxpayers. It allows a first-time noncompliant taxpayer to request abatement of certain penalties for a single tax period.

Individual taxpayers may request an FTA of a failure-to-file or failure-to-pay penalty. Business taxpayers can request an FTA of those penalties or of a penalty for failure to deposit payroll taxes. Taxpayers may also qualify for a penalty waiver or abatement under other provisions, including for reasonable cause, as well as under statutory provisions such as the Sec. 7508 exception for taxpayers in the armed services serving in a combat zone, and under other administrative waiver provisions.

To qualify, the taxpayer must demonstrate filing and payment compliance and a three-year clean penalty history. To meet the filing compliance requirement, the taxpayer must have filed, or filed a valid extension for, all currently required returns and not have an outstanding request from the IRS for an unfiled return. To meet the payment compliance requirement, the client must also have paid, or arranged to pay, any tax due. The client can have an open installment agreement, as long as payments are current.

To satisfy the clean penalty history requirement, the client cannot have had penalties of a "significant" amount assessed in the prior three years on the same tax return for which the client is requesting abatement. If the IRS rejects the request because of a small penalty assessment, tax practitioners should remind the IRS of the "significant" qualification in the IRM.

The client will *not* be disqualified from receiving an FTA based on lack of a clean penalty history if the client:

- Had a penalty assessed more than three tax years prior to the tax return in question.
- Had an estimated tax penalty assessed in the past three years.
- Received reasonable-cause relief from penalties in the past.
- Received an FTA more than three tax years prior to the tax return in question.
- Has penalties on subsequent tax years.

A practitioner may request an FTA by telephone (866-860-4259), through e-services (tinyurl.com/a7ao7u5), or in writing. For a phone or electronic request, if the client's case does not involve a compliance function, practitioners may call the IRS Practitioner Priority Service (PPS) line or use the IRS e-services Electronic Account Resolution (EAR) function. IRS Accounts Management representatives have authority to grant FTAs. There is an unpublished ceiling on the penalty amount that the IRS will abate under FTA by phone or e-services. The IRS will not confirm the ceiling, but this author's experience indicates it may be $1,000 or more.

When requesting an FTA in writing, provide other penalty relief arguments, including reasonable cause, to increase the client's chances of success. The request should be sent to the IRS service center where the client files paper returns.

If the client has reasonable-cause grounds for an abatement, present that argument first and request the abatement on those grounds. The client may need to use the FTA waiver for a subsequent year, and abatement due to reasonable cause will not disqualify the client from receiving an FTA.

If the client technically does not qualify for an FTA because of only one penalty assessed in the past three years but is otherwise compliant, present this history in conjunction with other arguments to the IRS for penalty abatement. If the client has multiple years of penalties, request an FTA for the first year if the prior three years have a clean compliance history. Present other arguments, such as reasonable cause, for subsequent years.

Practitioners should be aware that the IRS uses decision-support software called the Reasonable Cause Assistant (RCA) that has been found to often incorrectly determine FTA eligibility. IRS employees can, however, override the RCA. Be prepared by researching the client's clean compliance history and applying the qualification rules. If the client qualifies but the IRS representative says the client does not, ask the representative to override the RCA determination. If the representative will not override it, ask for his or her manager. If all other means have been exhausted, consider contacting the Taxpayer Advocate Service (TAS) for help. ❖

Editor's note: This article is condensed and adapted from "Using the First-Time Penalty Abatement Waiver" in the July 2013 issue of *The Tax Adviser.*

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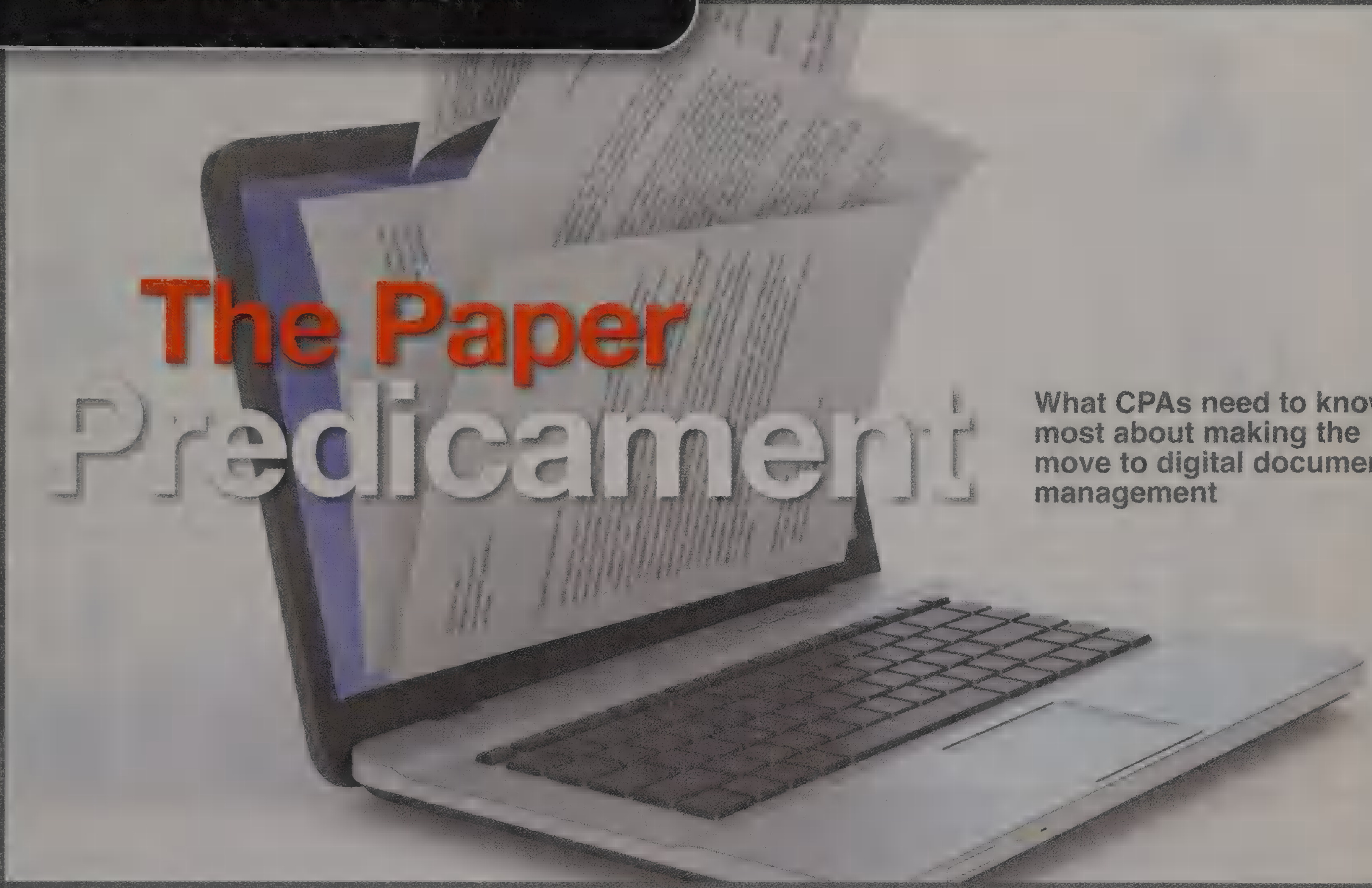

The Paper Predicament

What CPAs need to know most about making the move to digital document management


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From sole practitioners and small business owners to leaders at Big Four accounting firms and global financial executives, CPAs are taking every available measure to boost efficiency, build the bottom line, safeguard information, and, increasingly, become environmentally conscious. At the intersection of those pressures is the continuing move away from paper and toward digital document management.

Organizations each have their own story to tell about the path to paperless. In this Special Focus Report, four experts in digital solutions share their knowledge, insights, and best practice tips for creating and maintaining a paperless system.

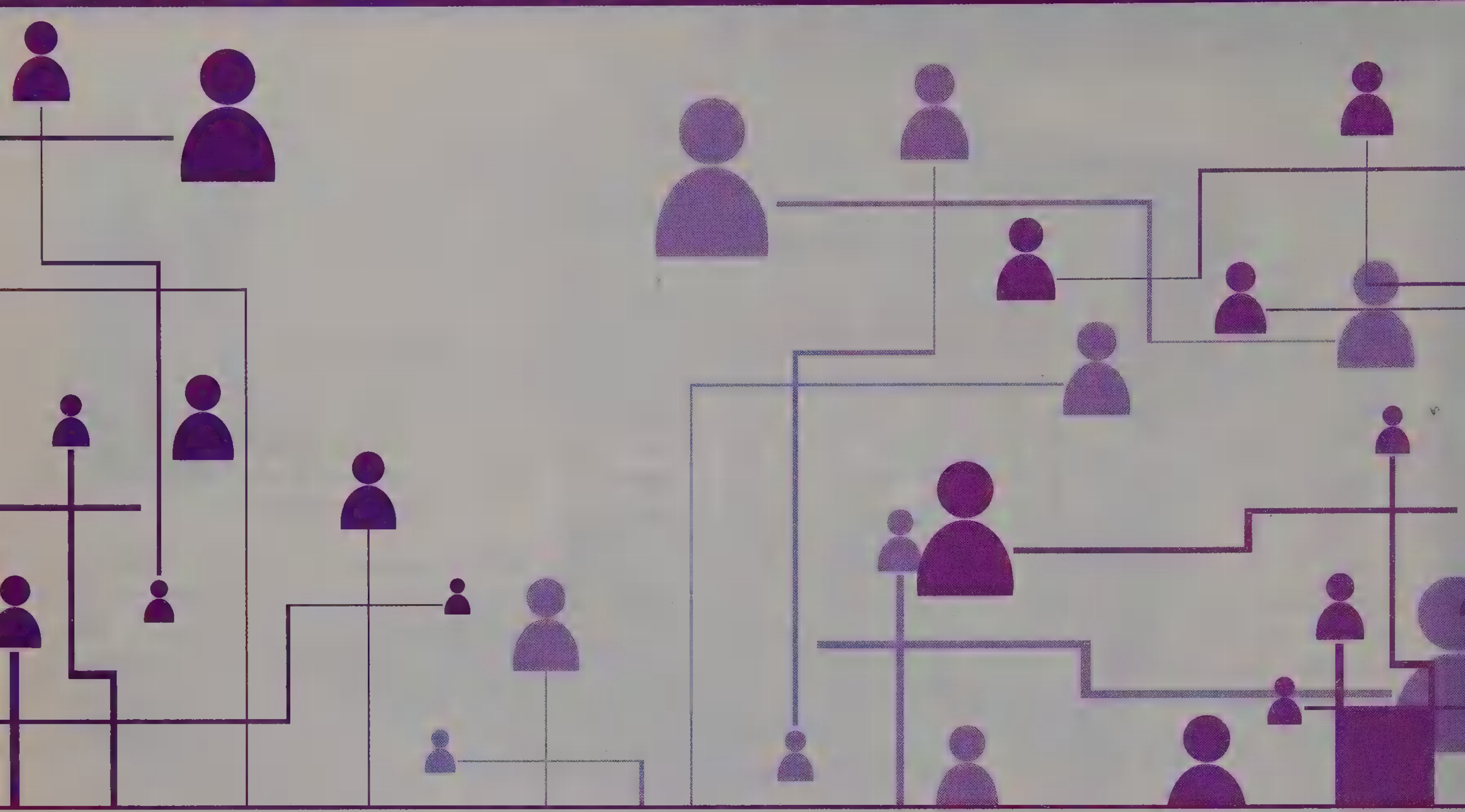
Contributing to the report are Teresa Mackintosh, software executive vice president and general manager at CCH, a part of Wolters Kluwer; Kerri Gibson, director, ATX Product Management for CCH Small Firm Services, a Wolters Kluwer Tax and Accounting company; Brock Philp, president and CEO of Doc.It; and Michael Alter, CEO and president of SurePayroll, a Paychex company.

What are the top considerations when creating and maintaining a digital document management system?

Michael Alter, SurePayroll: In today's business climate, CPAs are more mobile, with much of their business being conducted in the cloud using laptops, tablets, and smartphones. Despite this new environment, it is interesting that three of the top considerations for maintaining a digital management system fall under the same categories that would have applied 20 years ago.

As a business professional looking to go paperless, you want to account for accessibility, security, and disaster recovery. By doing so, you can operate your business on the go and whenever unexpected situations arise, such as during severe weather conditions or an electrical or system failure.

- Accessibility. Issues you should address include your system's ability to store and allow access to your information and your ability to quickly access documents



remotely should an on-site outage occur.

- Security. You want to be sure that the systems you choose have the highest levels of digital security. At SurePayroll, we employ multiple layers, firewalls, and anti-virus programs to keep client data secure. Also, our solutions range from an alarmed and monitored on-site security system with redundant power to encrypted databases and constant backups.
- Disaster recovery. In the wake of Hurricane Sandy and other devastating natural disasters that strike the United States each year, a reliable backup system is a top priority, even in a digital environment. You want to have a plan in place, preferably written, that is audited regularly to ensure that the team knows exactly when and how to access information from your designated backup systems.

Teresa Mackintosh, CCH: There are three top considerations when creating and maintaining a digital document management system.

- Ensure you have the correct processes in place. Moving to a digital document system is an opportunity to reevaluate the best practices that will help you drive incremental improvements and big wins.
- Use the latest integrated solutions across your work flows to achieve the most substantial gains in productivity and deliver the strongest capabilities for you and your clients or customers. The focus is not having only one step in the process performed best but having every step performed best within and across processes. There are solutions today, such as CCH Axcess™, that are built from the ground up and use the latest technology to support processes across an organization's entire work flow.
- Have employees on board and fully engaged in the new process. Obtain their input from the start, ensure that they understand the new processes and technology, and keep them involved in the ongoing evolution of your best practices and technology updates.

Brock Philp, Doc.It: All organization levels can benefit from a digital document management system. The following five considerations are key to success:

- Buy-in from leadership.
- A clear understanding across the organization of the reasons for the change to a digital document management system.
- Accurate documentation of existing processes before implementation.
- Ongoing update of processes to reflect new systems and procedures.
- Training, which includes new equipment, systems, and procedures designed to support and empower staff based on their job descriptions.

Kerri Gibson, CCH Small Firm Services: First and foremost, you need a system that meets the current needs of your practice and is able to grow with you over time. Scalability is critical across a number of dimensions. Your practice will grow in ways you may not even anticipate today, and your digital document management system has to be flexible enough to grow and adapt with you. That means being able to easily add more users, client accounts, and storage space. In addition, the system has to be intuitive and easy for your employees, and, in some circumstances, your clients to use.

How much money can an organization expect to make or save by going paperless?

Teresa Mackintosh, CCH: Digital opens the door to a new way of working—anywhere, anytime—and organizations that commit to serving clients and customers in this environment clearly have a competitive advantage.

The direct cost savings from going paperless are significant, with a paperless strategy capable of generating savings of 20% to 40% in expenses, ranging from paper to real estate costs. Benefits begin to mount further when these savings are combined with new revenue growth resulting from improved efficiency, productivity, mobility, and new client- and customer-service opportunities.

For CCH customers, the gains are even greater. The new cloud-based CCH Axcess™ Document helps organizations digitally organize and manage all types of documents—from tax returns and business correspondence to employee records and email. CCH offers a common database at the core of its tax and work flow solutions so files are centralized in a single, searchable database. The database makes it fast and easy to find the information you need, when you need it, and saves time updating data in multiple locations.

Also important is that organizations of all sizes can benefit from paperless work flows. CCH customer Armour Vickerman PLLC is an example of a smaller firm that has reduced office expenses by 20% and saved countless hours by going paperless and streamlining work with CCH Axcess™ Document. While doing so, the firm enhanced and further personalized its client services by using CCH Axcess™ Portal to exchange files and collaborate with clients. Among the results are newfound hours that are being spent with clients.

Michael Alter, SurePayroll: Depending on the business, the increase in efficiency, as well as paper and other cost savings found in operating a paperless business, could be substantial. We identified going paperless as one of the main considerations and benefits when we launched SurePayroll in 2000. We use the internet to reduce the overhead and costs required when processing payroll, and these savings are passed on directly to our customers. As a result, we are up to 50% less expensive than traditional providers.

Here are a few other types of savings and benefits to consider:

- Direct deposit savings. Most SurePayroll customers pay their employees through direct deposit, which avoids paper checks altogether. A study by the PayIt-Green Alliance, a nonprofit organization that represents 11,000 financial institutions, determined that having one U.S. employee paid bimonthly using direct deposit would save 1 pound of paper, eliminate the release of 4 gallons of wastewater and 1 pound of greenhouse gases, and save a business approximately $176 each year. At first glance these savings may not seem substantial, but for a small business owner, they amount to a significant savings over time.
- Operational savings. We estimate that a small business

can save an incremental $500 to $1,200 per year simply by adopting a paperless payroll system. Additionally, with an online payroll service, CPAs and their clients share online access to payroll information, which eliminates the need to print reports and send them by courier or mail.

- Increased productivity. Going digital means no more stuffing envelopes and check distribution to employees. SurePayroll ensures that CPAs and their small business clients save considerable time. We offer One-Click® Payroll, which allows payroll to be processed with a single mouse click, and we process tax filings CPAs would otherwise need to process themselves.
- More efficient work. When organizations no longer work with a paper-based payroll system and can direct employees to obtain their information online, they are no longer burdened with administrative tasks that can distract them from business-building and other more productive efforts.
- Seamless integration with other financial assets. When done correctly, paperless payroll extends far beyond the basic payroll functions. By building seamless ties with retirement savings programs, workers' compensation insurance coverage, and other employee-related interests, paperless payroll reduces the need to print reports, make duplicate data entries, and perform similar tasks.
- Storage savings and reduced clutter. With SurePayroll's online payroll solution, it is no longer necessary to store paper reports or back up payroll software data onto expensive backup drives. The solution reduces the need for purchasing filing cabinets and other storage units. However, equally important, it creates a clean, clutter-free, and productive work environment that leads to stronger business results and improved employee morale.

Kerri Gibson, CCH Small Firm Services: Savings and earnings will vary widely based on the practice's size. We have an online tool that allows you to calculate potential savings based not only on ink, paper, postage, storage furniture, and other hard costs but also on your soft costs, such as time spent filing and retrieving documents or meeting with clients to accept or deliver documents or returns. The amount of money earned by redirecting your time saved into revenue-generating activities, such as adding clients and delivering a higher level of service, is going to vary by firm.

What are the most common mistakes organizations can make when going paperless? How can they be overcome?

Kerri Gibson, CCH Small Firm Services: Mistakes tend to fall into one of two main categories: lack of time and lack of process definition. Converting to a paperless system requires time and planning. You need to consider more than just how your firm is going to operate going forward from the day you bring a digital management system online. That's only half the battle. The other half is managing the process of converting your existing documents to a digital format. That takes time, and you need to determine when you can afford to allocate the time

needed for implementation.

On the process side, most firms will budget time and resources to train their staff in using the digital document management system to meet existing work flow needs. For document exchange products such as PortalSafe, the gap lies in failing to consider how much you need to educate your clients on a new way of sharing, storing, and accessing documents so that they can interact with the system with a minimum of issues.

Teresa Mackintosh, CCH: The inclination to apply new technology to old processes may be the most common mistake. Organizations need to take a fresh look at both their own processes and the latest available technology, then determine if they have the best of both. The right technology, applied to the right processes and work flows, will deliver results that support the organization's highest level of productivity and directly enhance business relationships.

Brock Philp, Doc.It: Four common mistakes organizations make when going paperless are:

1. Not having buy-in from organizational leadership. Projects become more challenging when they are forced up the management ladder. Avoid this challenge by creating a vision that can be embraced by the CEO and other leaders that they can promote internally and externally.
2. Not having a clear and documented reason for moving to a digital system. The best approach is to have your new system evolve from a strong vision statement that supports the reasons your firm has undertaken the project.
3. Not including an authoritative, empowered, and motivated employee from each practice area or department on the project team. Document management systems impact every area of an organization and can ultimately change its culture. As culture shifts, employees tend to embrace it, grow, and become more effective, or they become less flexible, more self-interested, and eventually separate themselves from the organization as it moves forward. If a group does not have an informed team member to champion the project at its earliest phase, members of the group will be less likely to use and benefit from the new system.
4. Not having realistic expectations of the new system by believing that the software package will automatically "do it for them." If we could feed documents into a machine and produce client-ready tax returns and financial statements without the human element and required expertise, there would be far less need for CPAs. Document management software is a tool that needs to be explored, understood, tested, integrated, documented, trained, and maintained.

Safely storing documents rises to a higher priority level in a paperless environment because of the potential for a device failure. What are the most effective solutions and strategies for backing up documents?

Kerri Gibson, CCH Small Firm Services: Paperless environments provide so many more solution options for safe storage than a paper-based system. Physical documents can only be stored in one location, which creates a very specific set of risks. Paperless documents are electronic files. They can be backed up regularly, stored in multiple secure locations simultaneously, and accessed through systems that rely on a series of servers to guarantee 24/7 availability. Encryption for both transmission and online storage, whether on a local machine or in the cloud, has become a best practice. All of these factors are advantages over a paper-based storage system and make tax professionals confident when moving to an electronic storage system.

Brock Philp, Doc.It: Device failure and unforeseen incidents regarding property, plant, and equipment make effective backup strategies crucial. An effective solution is one that meets the requirements set forth in a firm's business continuity plan. The plan should spell out how long data restoration should take for different types of failures.

It should also detail intermediate stopgap procedures employees can take while waiting for restoration to occur. Depending on risk and cost analysis, these solutions fall somewhere between on-site nightly tape backups (which are moved and stored off-site) to bit-level cloud or remote-site online backups.

Over the past year, many regions across the country have been seriously impacted by natural disasters and other severe weather conditions. How can digital information best be protected during times of climate volatility?

Teresa Mackintosh, CCH: Unfortunately, recent natural disasters and other weather-related incidents have significantly affected CPA professionals, their businesses, and their clients and customers. However, technology can help minimize those risks with electronic files that are easier to back up and store off-site for access in case of disaster. Also, when working in the cloud, organizations can continue to fully work, access client and customer information, and serve clients and customers from anywhere—even under the most difficult circumstances.

How can an organization's digital system be successfully integrated with its other technology platforms?

Brock Philp, Doc.It: System integration is a broad issue. Over the years this has come to be understood by many as a desire for a "magic bullet" of software and database integration in which data flows automatically either within a single-vendor system or between software packages in best-of-breed systems. This is an accurate way to address the question. However, it is not the only or most important way.

Single-vendor systems are rarely employed because, while one tool in a suite may be outstanding, other tools offered by the same vendor may not be, especially when compared to the benefits gained by using offerings from separate vendors. Any time you have disparate systems, integration will, at some point, require human involvement. Integration at this point is a procedure. If the procedure is documented, trained, and updated, the various technology platforms at a firm can work seamlessly together, and costs can be reduced by pushing the integrative steps down to capable staff with the lowest effective billable rate.

How can the changing legal and industry requirements for sharing, storing, and retaining digital files be consistently met?

Teresa Mackintosh, CCH: Technology can be a great asset to firms to help ensure compliance and accuracy. With CCH Axcess, for example, automated retention capabilities help firms comply with regulations related to file retention and destruction (including email). And version control and collaboration features help ensure that everyone has access to the most recent version of a document.

Kerri Gibson, CCH Small Firm Services: Requirements and laws relating to the care and protection of digital files have changed significantly in the last few years, and we expect more changes, driven by technological advances, to come. In a perfect world, your document management software will keep you informed of changes in legal and industry requirements. Typically, software updates and enhancements are the ideal tools for ensuring that your system remains compliant with changing regulations. However, like any developing technology, needs and capabilities change quickly. At CCH SFS, in addition to making sure our products are always compliant, we are always working to keep our customers up to date by using a variety of communication tools.

What ranks among the greatest coming changes in paperless document management, and what technology and staffing are necessary to position such a change as an opportunity?

Brock Philp, Doc.It: What the industry is overlooking is the extension of the paper metaphor. Before digital document management in the accounting profession, workpapers and final documents did not require proprietary solutions to read, use, and share. Other vendors will eventually understand the importance of extending the paper metaphor to protect and support their clients. This means managing documents as editable, dynamic files while work is in process and as static, unchanging files once work is complete.

Most vendors have solutions for dynamic, editable document types and then fail to provide a nonproprietary, ubiquitous pillar of workpapers and client deliverables locked down in PDF or another easy-to-use format. It is important for maintaining the integrity of final documents, and it is important so that clients are not trapped in vendor solutions.

Kerri Gibson, CCH Small Firm Services: Fortunately, over the past few years, we have reached a point with technology infrastructure where applications and file storage are becoming increasingly transparent across both devices and distance. This trend will continue and enable businesses to communicate with their customers more conveniently, quickly, and efficiently than ever before. Over the next three years, we expect that great strides will be made in mobile scanning technology and large file delivery. On the horizon, we see excitement around electronic paper and thin-film transistor (TFT) technology. This advancement could potentially revolutionize the way we work with documents on a daily basis.

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PRACTICE & PROCEDURES

BASIS REPORTING FOR DEBT INSTRUMENTS AND OPTIONS IS PHASED IN

In final regulations (T.D. 9616), the IRS is phasing in basis reporting requirements under Sec. 6045(g) for debt instruments and options. The IRS took the action in response to comments about the complexity of complying with these rules and to give brokers ample time to develop and implement reporting systems. T.D. 9616 finalizes proposed regulations (REG-102988-11) released in November 2011. The final regulations were effective April 18.

Sec. 6045(g) requires securities brokers and other affected persons to report to the IRS and customers (on Form 1099-B, *Proceeds From Broker and Barter Exchange Transactions*) the adjusted basis of covered securities sold and whether any gain or loss upon their sale is long- or short-term. It requires securities brokers to begin providing this information for corporate stock purchased in 2011 and later years, or beginning in 2012 for stock for which an average-basis method is permissible under Sec. 1012.

Reporting on all other specified securities, including debt instruments and options, was to begin with securities acquired or granted after Dec. 31, 2012, but that date was delayed in earlier guidance, so that reporting is required for debt instruments and options acquired on or after Jan. 1, 2014 (Notice 2012-34). The final regulations delay this date even further for certain debt instruments and options.

Debt instruments. The IRS received many comments suggesting that a narrower range of debt instruments and options be subject to reporting, such as debt instruments with a fixed yield and maturity date. However, the IRS noted that Sec. 6045(g) by its terms covers a broad range of instruments. For debt instruments with less complex features, the regulations retain the Jan. 1, 2014, effective date. These include:

- Debt instruments that provide for a single fixed payment schedule for which a yield and maturity can be determined under Regs. Sec. 1.1272-1(b);
- Debt instruments that provide for alternate payment schedules for which a yield and maturity can be determined under Regs. Sec. 1.1272-1(c) (such as a debt instrument with an embedded put or call option); and
- A demand loan for which a yield can be determined under Regs. Sec. 1.1272-1(d).

The IRS did not agree to a request to delay reporting on instruments with embedded put or call options because, it said, too many securities would fall under that category.

Basis reporting applies to debt instruments acquired on or after Jan. 1, 2016, that are (1) a debt instrument that provides for more than one rate of stated interest (such as a debt instrument with stepped interest rates), (2) a convertible debt instrument, (3) a stripped bond or coupon, (4) a debt instrument that requires payment of either interest or principal in a non-U.S. dollar currency, (5) certain tax credit bonds, (6) a debt instrument that provides for a payment-in-kind feature, (7) a debt instrument issued by a non-U.S. issuer, (8) a debt instrument whose terms are not reasonably available to the broker within 90 days of the date the customer acquired the debt instrument, (9) a debt instrument issued as part of an investment unit, and (10) a debt instrument evidenced by a physical certificate unless the certificate is held (directly or through a nominee, agent, or subsidiary) by a securities depository or by a clearing organization. Non-fixed-yield and maturity date instruments, including contingent payment debt instruments, variable-rate debt instruments, and inflation-indexed debt instruments, will be subject to reporting only if issued after Jan. 1, 2016.

The final regulations retain the exemption from reporting in the proposed rules for debt instruments with principal subject to acceleration and add an exemption for short-term debt instruments (debt instruments with a fixed maturity date not more than one year from the date of issue). The IRS rejected a suggestion to exempt debt instruments with terms longer than one year that will mature in less than a year when transferred.

Another provision in the regulations concerns the consistency of reporting between different brokers when some permit their customers to make certain basis elections and others may not. Because this inconsistency could create problems when instruments are transferred between brokers, the final rules adopt default assumptions but require brokers to offer certain elections to customers. Under these rules, if a customer provides written notification, a broker must take into account the following elections for basis reporting purposes: the election to accrue market discount using a constant yield, the election to include market discount in income currently, the election to treat all interest as original issue discount (OID), and the spot rate election for interest accruals for a covered debt instrument denominated in a currency other than the U.S. dollar.

In addition, to improve consistency

between income reporting and basis reporting for debt instruments, T.D. 9616 contains new temporary regulations requiring, under Sec. 6049, brokers to report interest (OID) income to reflect amounts of amortized bond premium or acquisition premium for a covered debt instrument.

Options. The reporting requirements apply to the following options granted or acquired after Jan. 1, 2014: an option on one or more specified securities, including an option on an index, substantially all the components of which are specified securities; an option on financial attributes of specified securities, such as interest rates or dividend yields; and a warrant or stock right on a specified security. The scope provisions in the final regulations are generally the same as in the proposed regulations, except that the final regulations explicitly exclude a compensatory option. The final regulations also apply to any over-the-counter option on a specified security.

The regulations apply different reporting rules to Sec. 1256 options and non-Sec. 1256 options. For a nonequity option described in Sec. 1256(b)(1)(C) on one or more specified securities, brokers must use the Regs. Sec. 1.6045-1(c)(5) reporting rules that apply to a regulated futures contract. For an option on one or more specified securities that is not described in Sec. 1256(b)(1)(C), a broker will report gross proceeds and basis using the rules in the final regulations for a non-Sec. 1256 option.

For a cash-settled non-Sec. 1256 option, the regulations require a broker to adjust gross proceeds related to an option transaction by increasing gross proceeds by the amount of any payments received for issuing the option and decreasing gross proceeds by the amount of any payments made on the option. These rules for a cash-settled option are based on the idea that costs related to the acquisition of a position affect basis, while the costs related to the sale or closeout of a position affect gross proceeds.

In a change from the proposed regulations, the final regulations do not permit brokers to adjust basis to account for the exercise of a compensatory option that is granted or acquired on or after Jan. 1, 2014. The IRS says this approach will eliminate confusion and uncertainty for an employee who has exercised a compensatory option.

Largest Average Penalty Abatements: Fraud, Accuracy

Fraud civil penalties abated in fiscal 2012 on individual and business income tax returns and accuracy-related penalties for businesses, although relatively few, yielded average abatement amounts much higher than for most other more numerous abatements. The most numerous penalties and abatements were for individual failure to pay and business delinquency.

		Number	Amount (thousands)	Average
Individual and Fiduciary	Fraud	206	$10,967	$53,238
	Accuracy-related	58,661	$295,178	$5,032
	Delinquency	803,864	$2,970,749	$3,696
	Estimated tax	261,812	$267,065	$1,020
	Failure to pay	1,966,739	$1,514,161	$770
Business	Accuracy-related	124	$42,887	$345,863
	Fraud	5	$1,652	$330,400
	Estimated tax	8,743	$77,436	$8,857
	Bad check	537	$2,652	$4,939
	Delinquency	173,772	$489,419	$2,816

Source: [illegible] Abated, by Type of Tax and Type of Penalty, [illegible] tinyurl.com/[illegible] [illegible] tinyurl.com/[illegible]

EXEMPT ORGANIZATIONS

IRS FINDS WIDESPREAD NONCOMPLIANCE BY COLLEGES AND UNIVERSITIES

The IRS published its final report concerning its Colleges and Universities Compliance Project, finding compliance issues related to unrelated business taxable income (UBTI) and compensation practices. The IRS conducted the study to find out why colleges and universities had so much unrelated business activity but owed so little tax and to examine their compensation practices. The IRS examined tax returns from 34 colleges and universities it selected from among 400 it surveyed by questionnaire. The examined schools were divided almost evenly

between private and public institutions, with about two-thirds reporting enrollments greater than 15,000 students.

Unrelated business taxable income. An exempt organization, including exempt colleges and universities, must pay tax on income from an unrelated trade or business, defined as an activity not substantially related to the accomplishment of the organization's exempt purposes, even if the income from the business is used to support those purposes. Losses from one activity can offset income from another; however, continuing losses can indicate a lack of profit motive, which would disqualify the activity's losses from the netting process.

The IRS found that UBTI was underreported at 90% of the institutions examined, with a total understatement of more than $90 million from 30 unrelated activities. The majority of the activities with unreported UBTI were fitness and recreation centers, sports camps, advertising, facility rentals, arenas, and golf courses. Nearly half of the institutions had adjustments to UBTI from advertising and/or facility rentals, and about one-third had adjustments from fitness and recreation centers and sports camps, arenas, and/or golf courses. The report identified four primary reasons for understated UBTI: (1) lack of profit motive, (2) improper expense allocation, (3) misclassification of certain activities as exempt, and (4) miscalculated or unsubstantiated net operating losses.

The IRS reported that nearly 70% of the institutions examined reported losses from activities that lacked a profit motive since the activities had losses for many years. These activities should not have been classified as a trade or business, and the institutions improperly used the losses to offset income from unrelated trade or business activities. In addition, nearly 60% of the institutions reduced their UBTI by improperly allocating expenses to an unrelated trade or business activity that did not have the required proximate and primary relationship to the activity. Also, the IRS determined that more than 40% of the institutions incorrectly omitted income from activities they believed to be related to their tax-exempt purpose that were actually unrelated activities subject to tax.

Compensation. Sec. 4958 imposes an excise tax on unreasonable compensation paid by exempt organizations (in this case, private colleges and universities) to a disqualified person, namely, an officer, director, trustee, or key employee (ODTKE). An institution's compensation is presumed to be reasonable if the college or university (1) uses an independent body to review and determine the amount of compensation, (2) relies on appropriate comparability data to set the compensation amount, and (3) contemporaneously documents the compensation-setting process. The IRS found that the compensation of 94% of ODTKEs examined in the study was determined using a process intended to satisfy the rebuttable presumption requirement; however, 20% of the examined institutions failed to meet the requirement due to the use of inappropriate comparability data. The data was inappropriate because it was (1) from another institution not comparable to the examined school, (2) obtained from an independent firm but used without any adjustments to make it comparable to the examined school, or (3) obtained from a survey that did not precisely define compensation.

The IRS also examined the employment tax returns of 11 schools and found problems in all of them, resulting in increased taxable wages of more than $35 million. The adjustments were due to failure to include the value of the personal use of autos, houses, social club memberships, and travel as wages; failure to include the value of graduate tuition waivers as wages; failure to withhold taxes on wages of nonresident aliens; and misclassification of employees as independent contractors. Also, the retirement plans at eight schools were examined, resulting in wage adjustments at four institutions totaling $1,115,007 due to excess deferrals, additions, and loans related to Sec. 403(b) plans, and nonqualifying contributions to Sec. 457 plans.

Due to the compliance issues related to UBTI and compensation found at the colleges and universities examined, the IRS concluded that similar problems may exist across the tax-exempt sector and plans to look at these issues more broadly.

■ IRS, *Colleges and Universities Compliance Project Final Report*, available at tinyurl.com/brkhfz3

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HEALTH COVERAGE

PROPOSED RULES ADDRESS MINIMUM VALUE OF HEALTH COVERAGE FOR PREMIUM TAX CREDITS

The IRS issued proposed regulations for determining whether an eligible employer-sponsored health plan provides minimum value for purposes of the Sec. 36B health insurance premium tax credit (REG-125398-12). Individuals do not receive the credit if they are eligible for affordable coverage under an eligible employer-sponsored plan that provides minimum value. Employers whose employees receive the health insurance premium tax credit may be liable for the Sec. 4980H "assessable payment."

When the final regulations for Sec. 36B were issued in May 2012, they did not cover the definition of minimum value; the IRS requested comments on that issue (T.D. 9590, Notice 2012-31). In drafting the proposed rules, the IRS considered the comments it received.

Prop. Regs. Sec. 1.36B-6(a) states that a plan provides minimum value only if the plan's share of the total allowed costs of benefits provided to an employee is at least 60%. Minimum value may be calculated using one of four methods: (1) the minimum value calculator provided by the IRS and the Department of Health and Human Services (HHS) (calculated with adjustments provided in the regulations); (2) one of the safe harbors established by

the IRS and HHS (generally, plans that provide certain benefits within specified co-pay, deductible, and cost-sharing limits); (3) actuarial certification for nonstandard plans; or (4) for plans in the small group market (employers with a maximum of 100 employees or, in years before 2016, in states that elect, 50 employees), conforming with a level of coverage defined in 45 C.F.R. Section 156.140(b) (bronze, silver, gold, or platinum).

The proposed regulations also explain how wellness incentives (where a premium or other cost is reduced to encourage certain behaviors) are included in calculating minimum value. If the wellness incentives are tobacco-related, they are included in determining affordability (i.e., they would reduce the premium); otherwise, they are not included. The rules also explain how payments into health savings accounts and health reimbursement arrangements are included in calculating affordability.

The proposed regulations also:

- Define the term "rating area" used to determine costs of plans in the area in which the taxpayer lives;
- Define how retiree coverage is included as minimum essential coverage;
- Define coverage months for newborns and new adoptees;
- Explain how to calculate the adjusted monthly premium for family members not enrolled a full month (e.g., for a newborn child);
- Explain how to calculate the premium assistance amount when coverage is terminated before the last day of a month;
- Explain that premiums for family members residing in different states who enroll in different health plans can be added together; and
- Require taxpayers who receive advance payments of premium tax credits to file an income tax return to reconcile the payments by the due date for the return (including extensions) for the year they received the advance payments.

The regulations are proposed to apply to tax years ending after Dec. 31, 2013 (the first year the credit will be in effect).

REASONABLE COMPENSATION

SALARY WAS PARTIALLY REASONABLE

Relying on standards set by the Ninth Circuit, the Tax Court found that a sole shareholder's compensation from a wholly owned corporation for the year in question was partially deductible as reasonable compensation. The deductible compensation included catch-up payments for prior years' services.

Arthur Astor was the president and CFO of his wholly owned corporation, Aries Communications Inc. Since the company's formation in 1983, Astor was very involved in day-to-day operations and was a major factor in its success. In 2003 and 2004, Aries reported large sales of radio station assets through its subsidiaries, which resulted in large taxable income for those years. In the years before and after these sales, the company reported negative taxable income.

In 2004, Aries claimed a deduction of $6,896,974 for compensation to Astor. The IRS disallowed most of the 2004 deduction—$6,086,753—and determined a deficiency of $2,676,002 and an accuracy-related penalty under Sec. 6662(a).

The Tax Court relied on six factors to determine how much of the compensation was reasonable. The specific factors selected are those used by the Ninth Circuit, to which the case would be appealed (see *Elliotts, Inc.*, 716 F.2d 1241 (9th Cir. 1983), and *Metro Leasing & Dev. Corp.*, 376 F.3d 1015 (9th Cir. 2004)).

Three of the factors were not favorable for allowing the full compensation deduction claimed by Aries. After reviewing expert reports submitted by both Aries and the IRS that determined Astor's reasonable compensation based on compensation information from similar companies, the court found that the amount claimed by Aries for fixed compensation for the current and prior years was less than that paid by similar companies. However, the court rejected both experts' opinion on the reasonable part of Astor's bonus compensation and independently determined that only $2 million of the nearly $6.7 million bonus payment for 2004 was reasonable. Second, the company's character and condition indicated that Aries was thinly capitalized and in poor financial condition, supporting a much smaller deduction. Third, Astor had a potential conflict of interest in characterizing his economic reward for his work as salary rather than dividends, especially when he had been well-compensated for his efforts for the prior year's asset sale.

The court determined the factor of internal consistency in the treatment of payments to employees was neutral. Astor's compensation was not awarded under a structured, formal, consistently applied program; however, in 2004, it included amounts for prior years of hard work for which he had been undercompensated. Also, Astor's compensation could not be compared with other nonowner Aries employees because the company had no employees with duties similar to Astor's.

The court determined two factors were favorable: Astor's role in the company was obviously significant. He was very involved and important in the company's success and in the asset sales. Also, under the independent-investor standard (whether corporate profits, after paying the compensation, would provide a satisfactory return on equity for a hypothetical independent investor), the court found that Aries had sufficient net income and retained earnings to support Astor's compensation.

The court concluded that Aries could deduct $2,660,899, which consisted of $461,625 for prior years' underpayments, current annual salary of $199,274, and a $2 million bonus. The accuracy-related penalty was allowed.

Taxpayers should take steps to support the deduction of a large salary. The factors important to the appropriate court of appeals should be supported and docu-

mented. A record of dividends should be established, even if the amounts are relatively small.

■ *Aries Communications, Inc.*, T.C. Memo. 2013-97

*By **Laura Jean Kreissl**, Ph.D., assistant professor of accounting, and **Darlene Pulliam**, CPA, Ph.D., Regents Professor and McCray Professor of Accounting, both of the College of Business, West Texas A&M University, Canyon, Texas.*

FOREIGN ASSETS

GAO: FOREIGN ACCOUNT "QUIET DISCLOSURES" MAY BE MUCH HIGHER THAN DETECTED

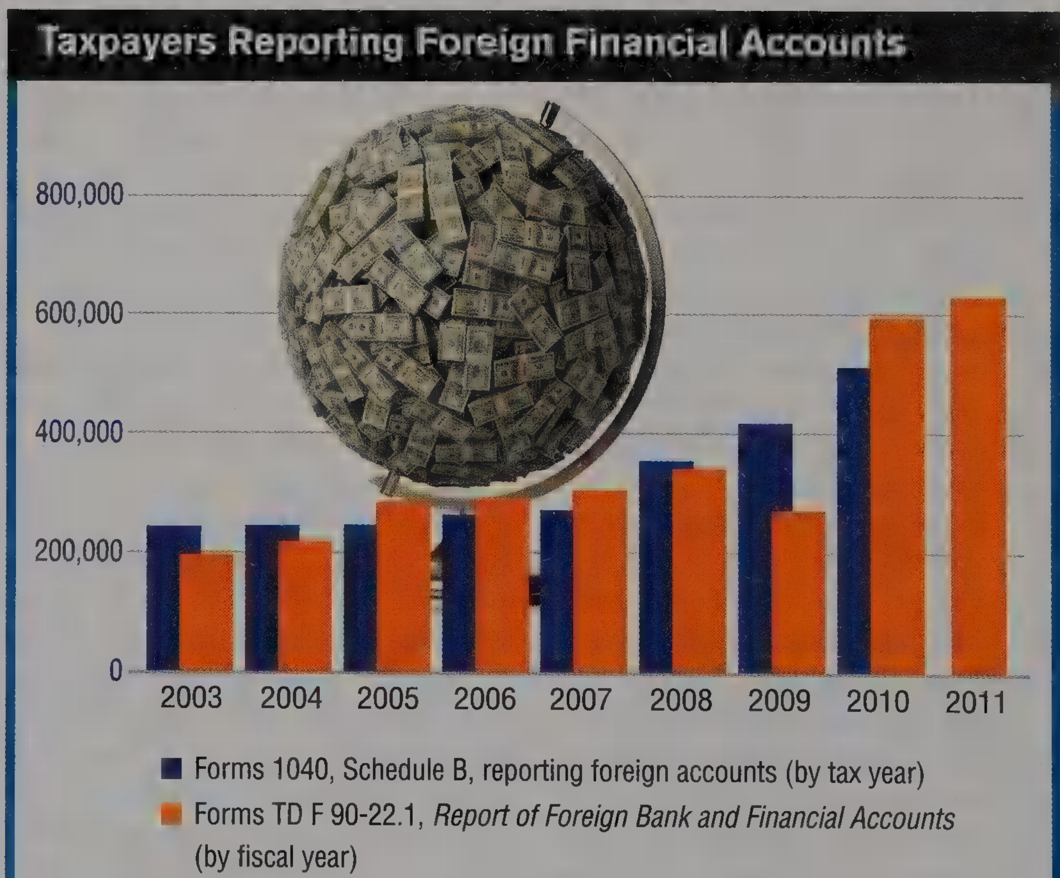
More than 10,000 taxpayers showed signs of having avoided offshore penalties by making "quiet disclosures" of foreign bank accounts for tax years 2003 through 2008, the U.S. Government Accountability Office (GAO) reported, a period for which the IRS has detected several hundred quiet disclosures. Filing data also suggest many more taxpayers may have begun reporting previously reportable foreign accounts on a recent current-year return without entering the government's offshore voluntary disclosure program (OVDP) or making a quiet disclosure for prior open years, the GAO said. While these taxpayers may have come into voluntary compliance going forward, they also thereby may have evaded all penalties and past-due taxes and interest on the accounts and income generated by them.

In the report, *Offshore Tax Evasion: IRS Has Collected Billions of Dollars, but May Be Missing Continued Evasion* (GAO-13-318), released April 26, the GAO gave results of its study of the effectiveness of the IRS's 2009 OVDP, which was the IRS's second OVDP and the most recent one with enough closed cases for analysis. The IRS also conducted OVDPs in 2003 and 2011, and has had one ongoing since 2012. In each, taxpayers have been allowed to apply to the IRS and, if they qualify, disclose their foreign accounts and pay taxes, interest, and tax-related penalties due for open years. In exchange, the IRS waives any criminal prosecution and limits the penalty for failing to disclose the accounts ("offshore penalty") to, in the 2009 OVDP, 20% of the highest aggregate value of the unreported accounts between 2003 and 2008 (the years covered by the 2009 OVDP). The penalty otherwise applicable to failing to properly file a Form TD F 90-22.1, *Report of Foreign Bank and Financial Accounts* (FBAR), is, for each year of violation, the greater of $100,000 or 50% of the balance in the account at the time of the violation.

The GAO identified 19,337 participants in the 2009 OVDP in 10,439 closed cases. The average offshore penalty assessed was about $376,000. Almost half the participants had accounts in Switzerland (a "John Doe" summons in 2008 for the names of U.S. account holders in Swiss bank UBS was a major factor driving participation in the 2009 OVDP). About half of the $4.1 billion in total revenues collected (as of the end of 2012) was from 378 cases. All the OVDP programs together have resulted in more than 39,000 disclosures and more than $5.5 billion in revenue as of December 2012.

Quiet disclosures. To identify potential quiet disclosures for years covered by the 2009 OVDP, the GAO identified taxpayers that had filed amended or late returns and FBARs for one or more of those years and excluded OVDP participants from this total. It found that 10,595 taxpayers met these criteria, indicating possible quiet disclosures. Of those, 3,386 taxpayers made the late or amended filings for multiple tax years—94 of them for all six years.

The IRS identified "several hundred" taxpayers (the report did not give a more specific number) as making quiet disclosures by similarly looking at amended returns for the period and screening out those with adjustments unrelated to offshore accounts. It also looked at amended returns with increased tax assessments



Source: U.S. Government Accountability Office, *Offshore Tax Evasion: IRS Has Collected Billions of Dollars, but May Be Missing Continued Evasion* (GAO-13-318), Figure 4, page 27, available at **tinyurl.com/cbze62x**.

PHOTO BY ISTOCKPHOTO/THINKSTOCK

over a certain threshold. The IRS also looked at FBARs filed or amended with amended returns, but only for those processed in 2009 and for the limited purpose of detecting movement of taxpayer assets from "non-secrecy" jurisdictions to those with financial secrecy laws.

New reporting. To estimate potential numbers of taxpayers newly reporting existing foreign financial accounts without making any disclosure concerning or amending prior returns, the GAO also looked at the overall increase between tax years 2003 and 2011 in FBAR filings and from fiscal 2003 to 2010 in returns that reported "yes" to the question on Schedule B, *Interest and Ordinary Dividends*, about whether the taxpayer owned or controlled a foreign financial account. The latter more than doubled in that period to 515,635 (see related graphic). As a percentage of all taxpayers filing Schedule B, they rose from approximately 1% in 2003 through 2007 to more than 2.5% in 2010. Similarly, the number of FBARs filed more than tripled to 618,134 from fiscal 2003 to 2011, and more than doubled between 2009 and 2010. Reasons for the increase could include taxpayers who had complied with income reporting requirements previously but only belatedly realized the need to also answer the question on Schedule B affirmatively and file an FBAR, the GAO noted.

"However," it added, "such a sharp increase … amidst the global economic recession and the publicity surrounding IRS's offshore programs raises the question whether some of these taxpayers may have attempted to circumvent some of the taxes, interest, and penalties that would otherwise be owed."

The IRS agreed with the GAO's recommendations that it use similar methods to more effectively detect and pursue quiet disclosures and previously unreported foreign financial accounts and to use offshore data to educate taxpayers about compliance.

Tax Matters editor Paul Bonner can be reached at pbonner@aicpa.org or 919-402-4434.

TOKYO, HONG KONG AGAIN TOP IRS HIGH-COST HOUSING LIST

Tokyo and Hong Kong have the highest allowable housing costs for 2013 for purposes of the foreign housing exclusion under Sec. 911(c). The limitation for Tokyo is $320.82 per day, or $117,100 for the year. For Hong Kong, it is $313.15 a day, or $114,300 for the year. The cities are followed, in order, by Moscow; Geneva; Osaka-Kobe, Japan; and Singapore (see below).

World's Highest Sec. 911 Housing Cost Exclusions

Location	2013 limitation
1. Tokyo	$117,100
2. Hong Kong	$114,300
3. Moscow	$108,000
4. Geneva	$98,300
5. Osaka-Kobe, Japan	$90,664
6. Singapore	$89,800
7. London	$88,200
8. Luanda, Angola	$84,000
9.-13. Paris and 4 suburbs	$82,500
14. Milan	$82,100

The cities are among 288 places the IRS identified in Notice 2013-31, an annual update, as having allowable foreign housing exclusions above the otherwise applicable limitation for 2013 of $29,280. The top five high-cost cities are the same as in the 2012 list (see Notice 2012-19).

Subject to limitations, qualified individual taxpayers may elect to exclude from gross income under Sec. 911(a) their foreign earned income and foreign housing costs. The individual must meet the bona fide residence or physical presence test. The income exclusion and housing cost exclusion together may not exceed the taxpayer's foreign earned income for the year.

The foreign housing cost exclusion is further limited to 30% of the foreign earned income limitation, as adjusted for inflation, or, for all of 2013, $29,280 of qualifying housing costs above a threshold amount of 16% of the foreign earned income exclusion limitation, or, for 2013, $15,616. The IRS is authorized by Sec. 911(c)(2)(B) to adjust the 30% limitation amount based on geographical differences in housing costs relative to those in the United States, which it does annually.

Five locations in France took ninth through 13th places in 2013: Paris and its suburbs of Garches, Sèvres, Suresnes, and Versailles. All were just behind Luanda, the capital of Angola, which is undergoing an oil-related economic boom but whose per capita GDP of $6,200 remains less than one-eighth that of the United States (CIA, *The World Factbook*).

Notice 2013-31 is effective for tax years beginning on or after Jan. 1, 2013; however, taxpayers may elect to apply it to their 2012 tax return instead of the otherwise applicable adjusted limitation in the 2012 notice.

HSA FIGURES FOR 2014 ANNOUNCED

For calendar 2014, the inflation-adjusted limitations on deductible or excludible contributions to a health savings account (HSA) under Sec. 223 will be:

- Individual with self-only coverage under a high-deductible health plan (HDHP): $3,300.
- Individual with family coverage under an HDHP: $6,550.

The amounts are slightly higher than for 2013 ($3,250 and $6,450, respectively). The additional contribution amount for individuals 55 and older remains unchanged at $1,000.

An HDHP's minimum annual insurance deductible for 2014 will be unchanged from 2013 at $1,250 for self-only coverage and $2,500 for family coverage. Maximum out-of-pocket expenses allowable under an HDHP (other than premiums) will be $6,350 for self-only coverage and $12,700 for family coverage (up from $6,250 and $12,500, respectively, in 2013).

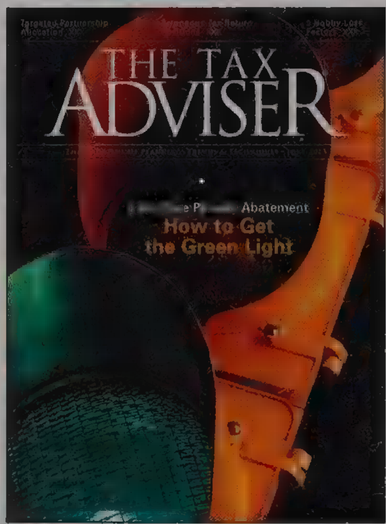
The updated amounts are in Rev. Proc. 2013-25. ❖

EMPLOYEES VS. INDEPENDENT CONTRACTORS

Voluntary Classification Settlement Program

Determining proper classification of workers, either as independent contractors or employees, can be a subjective challenge for employers. The determination of whether a worker is an employee or an independent contractor is based on the facts and circumstances surrounding the individual's work for the employer. Generally, the more the employer is able to control and direct the worker, the more likely the worker should be classified as an employee.

Worker classification issues uncovered in an audit can lead to costly assessments of past employment taxes, penalties, and interest for reclassified employees. Nontax exposure, such as reclassified workers' benefit provisions, may also exist. Representatives and practitioners serving taxpayers at risk for worker reclassification should carefully consider the alternatives available to assist taxpayers in becoming compliant. One alternative is the Voluntary Classification Settlement Program (VCSP).



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GENEROUS RELIEF FROM LIABILITY

Before the VCSP was established, only taxpayers under audit could resolve worker classification issues and obtain relief from federal employment taxes through the IRS's Classification Settlement Program (CSP). The IRS established the VCSP to allow taxpayers to come into compliance prospectively while obtaining generous relief from liability for past federal employment taxes. In exchange for voluntary compliance and reclassification of workers as employees, the taxpayer receives the following relief:

1. The taxpayer pays 10% of the employment tax liability that would have been due on compensation paid to the workers being reclassified for the most recent tax year (determined under the reduced rates of Sec. 3509(a));
2. The taxpayer is not liable for any interest and penalties on the liability; and
3. The taxpayer is not subject to an employment tax audit of the worker classification of the class or classes of workers for prior years.

VCSP ELIGIBILITY

To participate in the program, a taxpayer must meet eligibility requirements spelled out in Announcement 2012-45, which modified the prior rules, to permit a taxpayer under IRS audit, other than an employment tax audit, to be eligible to participate in the VCSP. In addition, Announcement 2012-45 eliminated the earlier requirement that a taxpayer agree to extend the period of limitation on assessment of employment taxes as part of the VCSP closing agreement. These modifications favor the taxpayer and further encourage participation in the VCSP.

To participate in the VCSP, eligible taxpayers must apply by filing Form 8952, *Application for Voluntary Classification Settlement Program*.

Considering the favorable relief available under the VCSP, taxpayers at risk for worker reclassification should consider the benefits of applying for and participating in the program. Participating in the program not only provides relief from penalties, but also provides taxpayers with a higher level of certainty about the proper classification of their workers.

A word of caution is in order, though. Most states do not coordinate with the IRS's VCSP. As such, state tax treatment of taxpayers that participate in the federal program is uncertain.

For a detailed discussion of the issues in this area, see "Options for Compliance With Worker Classification Rules," by Amy Lehmkuhl, CPA, in the July 2013 issue of *The Tax Adviser*.

—Alistair M. Nevius, editor-in-chief
The Tax Adviser

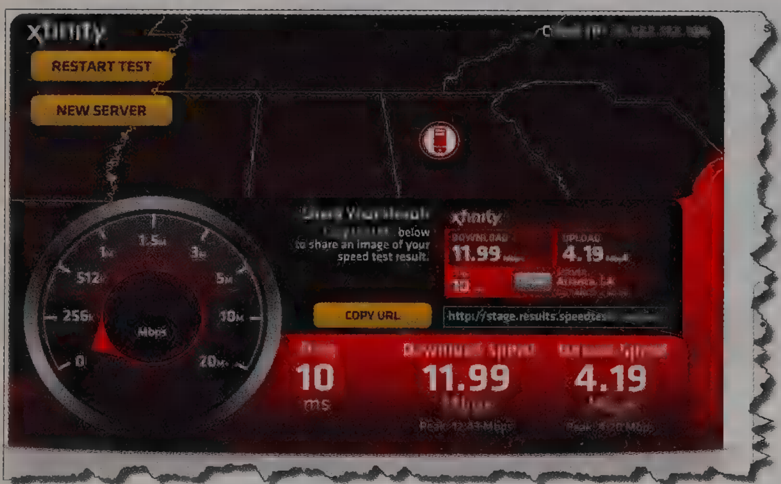
Technology Q&A

by J. Carlton Collins, CPA

A GOOD MEASURE

Q How can we tell if our internet service provider is delivering the internet speed we are paying for?

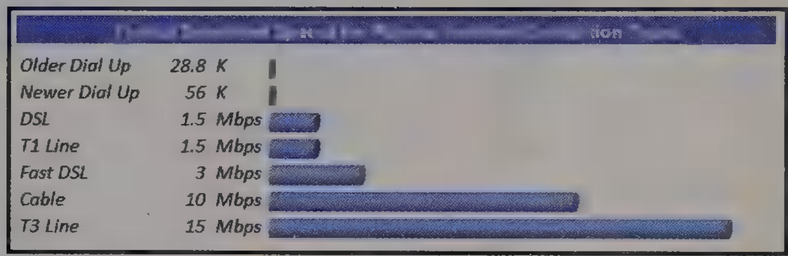
A There are many web-based internet speed tests, but use caution: Some so-called "speed tests" also install malware on your computer. For this reason, I like to use reputable speed tests such as the one provided by Xfinity at speedtest.comcast.net. Just visit the website and click on a server on the U.S. map under the "Speed Test" headline. The tool then will test the speed of your internet connection to that server. In my test, I scored a download speed of 11.99 megabits per second (Mbps) and an upload speed of 4.19 Mbps.



Note that by clicking the **NEW SERVER** button, you can test your internet speed to various locations throughout the United States. Generally, the farther the server is from you, the slower the internet speed is because the data must pass through more routers, and each router represents a potential bottleneck.

The Xfinity test does not install any software on your computer, and it works almost instantaneously. The test is performed by pinging the server 10 times, then averaging those times to determine the final result. (The Xfinity speed test measures the performance for any internet service provider (ISP), not just Xfinity.)

I recommend you use the **Print Screen** key or the Windows **Snipping Tool** to capture the report and paste it into a Word document saved as "Internet Speed Tests." Repeat this test periodically and capture the results to document your internet speed. These test results will help you determine whether you are receiving the internet speed you are paying for, and over time allow you to detect any changes in speed. Because each new ISP customer in your locality shares the same bandwidth and routers, your internet speeds eventually may decline. If this happens, you should ask your ISP to upgrade its capacities in your area to restore the contracted internet speeds (I admit that I have done this myself, multiple times). Use the following table and bar chart to evaluate your reported internet speed:



Note: The Xfinity speed test uses Flash, which is not supported by Apple's iOS operating system. Apple iOS users should use the speed tests at att.com/speedtest or speedtest.net.

A BIT CONFUSING

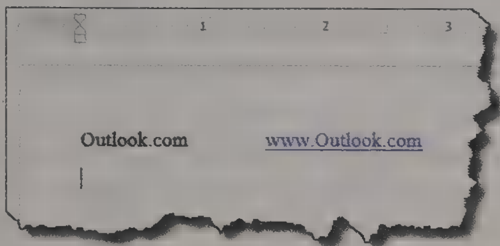
Q When installing Office 2013 on my 64-bit computer running a 64-bit operating system, the Microsoft installation routine recommends installing the 32-bit version of Office 2013, but it also provides the 64-bit option of Office 2013, which seems to be the more obvious option. Which do you recommend and why?

A It is true that the Microsoft Office 2013 installation routine recommends you install the 32-bit version, but the installation routine's small print explains this recommendation. The 32-bit version is compatible with 32-bit add-ons and plug-ins, whereas the 64-bit is not. Additionally, the 64-bit version does not support the ActiveX controls library (which contains ActiveX controls used to build solutions commonly used in Access, Excel, and Word), or SharePoint list controls. If these items are nonissues for you, then installing the 64-bit version of Office 2013 is the better option. The advantage of running the 64-bit version is support for larger files, faster performance, and superior bragging rights at cocktail parties.

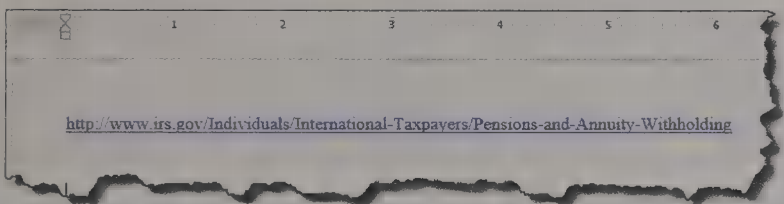
THREE WORD-BASED HYPERLINK QUESTIONS

Q Why is it that sometimes when I type a webpage address in Word, it converts to a hyperlink automatically, and sometimes it does not?

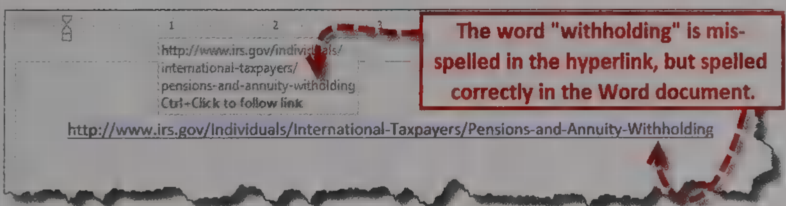
A Word recognizes and converts to a hyperlink webpage addresses containing "www" (such as www.irs.gov), but not those that don't (such as irs.gov). The next time your webpage address fails to convert to a hyperlink, insert a "www." in front of the webpage address, position your cursor after the last letter of the webpage address, and press the space bar to convert it to a hyperlink.



Q I am baffled by this. I received a Word document containing a hyperlink, but when I click it, my browser says it cannot find the webpage, even though the web address is correct (see attached file). Can you tell me why this is happening?



A If you look closely, there are forensic signs that suggest what is causing your hyperlink problem. Specifically, the hyperlink and the hyperlinked text do not match.

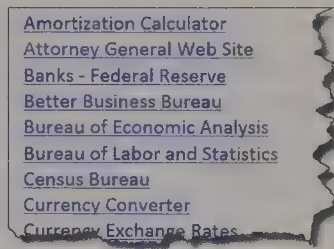


If you create a hyperlink in Word 2007 (or earlier Word editions), then later edit the hyperlinked text, Word 2007 does not automatically update the hyperlink to match that text. Thereafter, the hyperlink remains incorrect, even for users opening the document in Word 2010 or 2013. It appears that the author of your document originally created this hyperlink in Word 2007 (or an earlier edition), then edited the linked text.

Note: It is not possible to create this type of error in Word 2010 and 2013, as those editions of Word automatically update hyperlinks as the hyperlinked text is edited.

Q I received the attached Word document (pictured atop the next column), but I can't get the hyperlinks to work. What am I doing wrong?

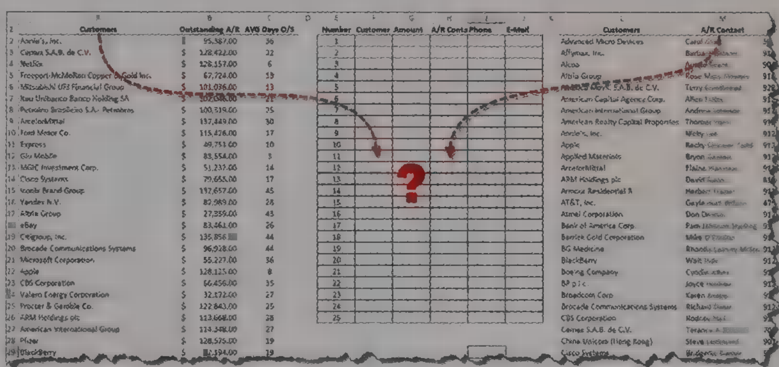
A The Word document you forwarded to me does not contain hyperlinks: The author of that document used blue text and underline formatting to make those web addresses look like



hyperlinks. Either the author wanted to make that text look like hyperlinks for printing purposes, he doesn't know better, or perhaps he sent this document to you on April Fools' Day.

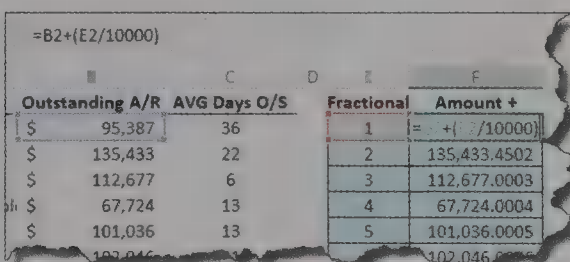
A LARGE PROBLEM

Q Each day I export a list of outstanding accounts receivable balances consisting of several thousand customers, and it is my job to produce a report containing the customers with the 25 highest outstanding balances for follow-up. As illustrated below, the problem is that the accounting system produces a list of the customers, balances, and days outstanding (columns A–C below), but I have a separate list of the A/R customer contact information (columns O–R) that must be merged into the final report. Right now I sort columns A–C by outstanding balance and copy the top 25 rows to my report area. I then hunt and peck for the corresponding 25 rows of contact information, copying and pasting each one separately to my report. I'm sure there is an easier solution. Can you please give me a clue?



A Excel's **Large** function, coupled with the **Match**, **Index**, and **Vlookup** functions, can help you get the job done quicker. You've already done a good job of setting up your worksheet layout; you just need to fill in a few formulas using these four steps.

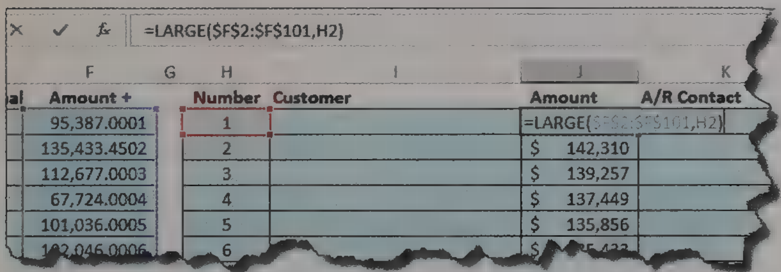
1. ***Eliminate duplicates.*** To eliminate the possibility of two identical outstanding A/R balances, add a unique fractional amount to each outstanding A/R balance, as follows. Insert two new columns (columns E and F in the screenshot below) labeled



Fractional and Amount+. Number the Fractional column E sequentially, starting with the value "1." In the Amount+ column, create a formula adding the outstanding A/R balance from column B to a fractional amount using the Fractional column E as the numerator and the value "10,000" as the denominator (as shown on the previous page), then copy the formula down.

This measure eliminates any identical balances that would otherwise cause problems using the **Match** or **Vlookup** functions.

2. ***Extract 25 largest values.*** In cell J2, enter the function =LARGE($F$2:$F$101,H2) to extract and return the largest outstanding balance, then copy the function down to cells J3 through J26. The **Large** function searches the list of values you specify and returns the value that corresponds to the rank you specify. In the example below, the **Large** function in cell J2 looks in column F for the Nth largest value, based upon the function's second attribute, which references the value "1" in cell H2.



=LARGE($F$2:$F$101,H2)

Amount +	Number	Customer	Amount	A/R Contact
95,387.0001	1		=LARGE($F$2:$F$101,H2)	
135,433.4502	2		$ 142,310	
112,677.0003	3		$ 139,257	
67,724.0004	4		$ 137,449	
101,036.0005	5		$ 135,856	

As this function is copied downward, the second attribute changes each time to reference the second-, third-, fourth-highest values, and so on until a list of the top 25 values has been reported.

3. ***Extract company names.*** In cell I2, enter the function =MATCH(J2,F:F,0) to return the company name corresponding with the outstanding A/R amount (be sure to add the 0 (zero) attribute to the end of the function to force an exact match).

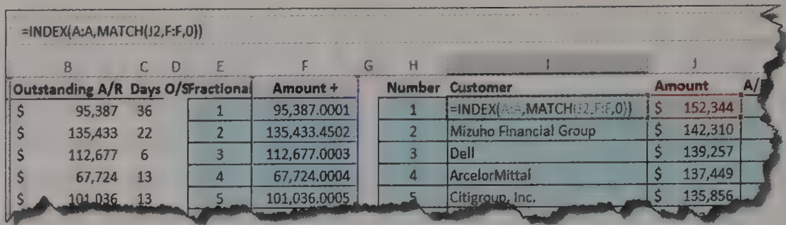
The **Match** function compares the value (now reported in column J) against the list of outstanding A/R values (in column F), and returns the row number where that value is positioned (row 33 corresponds with the value reported in cell J2 in this example).

Again in cell I2, edit the formula by adding the **Index** function, which uses the information returned by the **Match** function to fetch the company name from the 33rd row in column A. The completed formula containing the two nested functions appears as follows:

=INDEX(A:A,MATCH(J2,F:F,0))

Copy this formula downward to the next 24 rows.

Note A: Ordinarily, the **Vlookup** is easier to use, but because the lookup value (in column F) is not positioned to the left of the company name (in column A), we use the **Match** and **Index** functions instead to avoid the need to rearrange the source data.

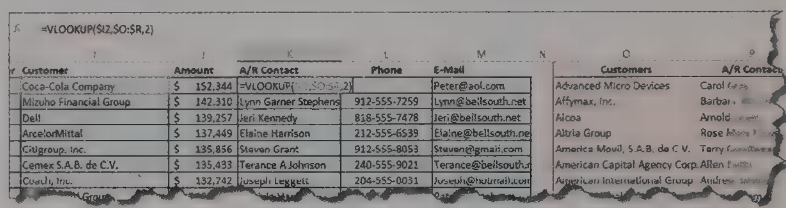


=INDEX(A:A,MATCH(J2,F:F,0))

Outstanding A/R	Days O/S	Fractional	Amount +	Number	Customer	Amount
$ 95,387	36	1	95,387.0001	1	=INDEX(A:A,MATCH(J2,F:F,0))	$ 152,344
$ 135,433	22	2	135,433.4502	2	Mizuho Financial Group	$ 142,310
$ 112,677	6	3	112,677.0003	3	Dell	$ 139,257
$ 67,724	13	4	67,724.0004	4	ArcelorMittal	$ 137,449
$ 101,036	13	5	101,036.0005	5	Citigroup, Inc.	$ 135,856

Note B: Notice that without the addition of the fractional values in step 1, this formula would erroneously return the same company name for duplicate outstanding A/R balances, which is why step 1 is necessary.

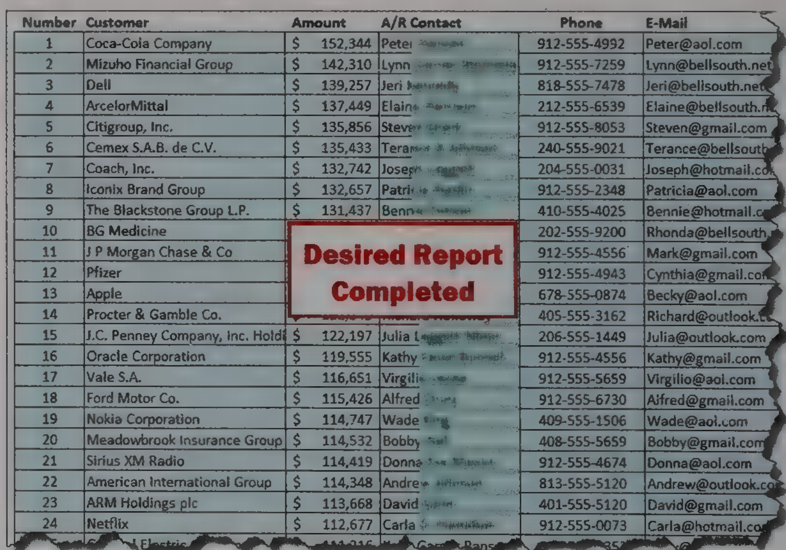
4. ***Extract remaining data.*** The remaining report data can now be easily extracted from the second table array (in columns O through R) using a **Vlookup** function with the company name as the lookup criteria. Enter the functions =VLOOKUP($I2,$O:$R,2), =VLOOKUP($I2,$O:$R,3), and =VLOOKUP($I2,$O:$R,4) in cells K2, L2, and M2, respectively, and copy them down.



=VLOOKUP($I2,$O:$R,2)

Customer	Amount	A/R Contact	Phone	E-Mail	Customers	A/R Contact
Coca-Cola Company	$ 152,344	=VLOOKUP($I2,$O:$R,2)		Peter@aol.com	Advanced Micro Devices	Carol
Mizuho Financial Group	$ 142,310	Lynn Garner Stephens	912-555-7259	Lynn@bellsouth.net	Affymax, Inc.	Barbara
Dell	$ 139,257	Jeri Kennedy	818-555-7478	Jeri@bellsouth.net	Alcoa	Arnold
ArcelorMittal	$ 137,449	Elaine Harrison	212-555-6539	Elaine@bellsouth.ne	Altria Group	Rose
Citigroup, Inc.	$ 135,856	Steven Grant	912-555-8053	Steven@gmail.com	America Movil, S.A.B. de C.V.	Terry
Cemex S.A.B. de C.V.	$ 135,433	Terance A Johnson	240-555-9021	Terance@bellsouth.	American Capital Agency Corp.	Allen
Coach, Inc.	$ 132,742	Joseph Leggett	204-555-0031	Joseph@hotmail.com	American International Group	Andrew

The final result is that the desired report is completed using data from the two table arrays. As the data in columns A–C are updated, so too is the report, ranked in order of the top 25 largest outstanding A/R balances.



Number	Customer	Amount	A/R Contact	Phone	E-Mail
1	Coca-Cola Company	$ 152,344	Peter	912-555-4992	Peter@aol.com
2	Mizuho Financial Group	$ 142,310	Lynn	912-555-7259	Lynn@bellsouth.net
3	Dell	$ 139,257	Jeri	818-555-7478	Jeri@bellsouth.net
4	ArcelorMittal	$ 137,449	Elaine	212-555-6539	Elaine@bellsouth.n
5	Citigroup, Inc.	$ 135,856	Steven	912-555-8053	Steven@gmail.com
6	Cemex S.A.B. de C.V.	$ 135,433	Terance	240-555-9021	Terance@bellsouth
7	Coach, Inc.	$ 132,742	Joseph	204-555-0031	Joseph@hotmail.co
8	Iconix Brand Group	$ 132,657	Patricia	912-555-2348	Patricia@aol.com
9	The Blackstone Group L.P.	$ 131,437	Bennie	410-555-4025	Bennie@hotmail.c
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11	J P Morgan Chase & Co			912-555-4556	Mark@gmail.com
12	Pfizer			912-555-4943	Cynthia@gmail.co
13	Apple			678-555-0874	Becky@aol.com
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15	J.C. Penney Company, Inc. Holdi	$ 122,197	Julia	206-555-1449	Julia@outlook.com
16	Oracle Corporation	$ 119,555	Kathy	912-555-4556	Kathy@gmail.com
17	Vale S.A.	$ 116,651	Virgilio	912-555-5659	Virgilio@aol.com
18	Ford Motor Co.	$ 115,426	Alfred	912-555-6730	Alfred@gmail.com
19	Nokia Corporation	$ 114,747	Wade	409-555-1506	Wade@aol.com
20	Meadowbrook Insurance Group	$ 114,532	Bobby	408-555-5659	Bobby@gmail.com
21	Sirius XM Radio	$ 114,419	Donna	912-555-4674	Donna@aol.com
22	American International Group	$ 114,348	Andrew	813-555-5120	Andrew@outlook.co
23	ARM Holdings plc	$ 113,668	David	401-555-5120	David@gmail.com
24	Netflix	$ 112,677	Carla	912-555-0073	Carla@hotmail.co

Note C: Ordinarily, I would position the second table array (columns O–R) on a separate worksheet. Instead, I positioned all data and calculations on the same worksheet for simplicity.

Note D: In the **Match**, **Index**, and **Vlookup** functions, I referenced entire columns rather than the data range (for simplicity), which assumes there is no other data in that column.

Download this Excel file (2013 or 2003 versions) at carltoncollins.com/large.xlsx or carltoncollins.com/large.xls.

FIVE iPAD TIPS

1. ***View full URLs.*** In Safari, holding your finger on any hyperlink for a few seconds reveals the full URL and also allows you to copy that URL.
2. ***Full-screen videos.*** You can increase the size of a video to full-size screen by tapping twice on the video. Pinch the video to return it to its original size.
3. ***The Google Maps curl on the iPad.*** It's not completely obvious when viewing a Google map on your iPad, but swiping the curl in the bottom-right corner reveals a menu of options for viewing Classic, Satellite, Hybrid, or Terrain maps, as well as traffic overlays.
4. ***Pin a location.*** On the Google Maps app, hold your finger on any point on the map for a few seconds to place a pin. A pop-up then displays options for accessing street view, getting directions, or sharing that location via email.
5. ***Convert your iPad into a Picture Frame slideshow.*** To enable Picture Frame mode, tap the flower icon in the bottom-right corner of the iPad's Lock screen. To adjust your slideshow, select **Settings**, **Picture Frame**, and then select your desired images, transitions, and options. As a promotional device, you might set up an iPad in your company's lobby to continuously display slides of your company's products, services, or history. ***Note:*** If you use a Passcode Lock, you'll need to go to **Settings**, **General**, **Passcode Lock**, and slide **Picture Frame** to **On** to enable Picture Frame mode from the Lock screen. ❖

J. Carlton Collins (carlton@asaresearch.com) is a technology consultant, CPE instructor, and a JofA *contributing editor.*

Note: *Instructions for Microsoft Office in "Technology Q&A" refer to the 2013, 2010, and 2007 versions, unless otherwise specified.*

Submit a question

Do you have technology questions for this column? Or, after reading an answer, do you have a better solution? Send them to jofatech@aicpa.org. We regret being unable to individually answer all submitted questions.

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OFFICIAL RELEASES

GASB NO. 70

Statement No. 70 of the Governmental Accounting Standards Board–*Accounting and Financial Reporting for Nonexchange Financial Guarantees*

Space considerations prevent publishing here the appendices to GASB Statement No. 70. Since the appendices often are important to understanding GASB statements, readers are advised to obtain complete copies. For additional copies of the statement and information on applicable prices and discount rates, contact the GASB Order Department, 401 Merritt 7, PO Box 5116, Norwalk, CT 06856-5116. Telephone: 1-800-748-0659. Website: www.gasb.org. Ask for Product Code No. GS70.

SUMMARY

Some governments extend financial guarantees for the obligations of another government, a not-for-profit organization, a private entity, or individual without directly receiving equal or approximately equal value in exchange (a nonexchange transaction). As a part of this nonexchange financial guarantee, a government commits to indemnify the holder of the obligation if the entity or individual that issued the obligation does not fulfill its payment requirements. Also, some governments issue obligations that are guaranteed by other entities in a nonexchange transaction. The objective of this Statement is to improve accounting and financial reporting by state and local governments that extend and receive nonexchange financial guarantees.

This Statement requires a government that extends a nonexchange financial guarantee to recognize a liability when qualitative factors and historical data, if any, indicate that it is more likely than not that the government will be required to make a payment on the guarantee. The amount of the liability to be recognized should be the discounted present value of the best estimate of the future outflows expected to be incurred as a result of the guarantee. When there is no best estimate but a range of the estimated future outflows can be established, the amount of the liability to be recognized should be the discounted present value of the minimum amount within the range.

This Statement requires a government that has issued an obligation guaranteed in a nonexchange transaction to report the obligation until legally released as an obligor. This Statement also requires a government that is required to repay a guarantor for making a payment on a guaranteed obligation or legally assuming the guaranteed obligation to continue to recognize a liability until legally released as an obligor. When a government is released as an obligor, the government should recognize revenue as a result of being relieved of the obligation. This Statement also provides additional guidance for intra-entity nonexchange financial guarantees involving blended component units.

This Statement specifies the information required to be disclosed by governments that extend nonexchange financial guarantees. In addition, this Statement requires new information to be disclosed by governments that receive nonexchange financial guarantees.

The provisions of this Statement are effective for reporting periods beginning after June 15, 2013. Earlier application is encouraged. Except for disclosures related to cumulative amounts paid or received in relation to a nonexchange financial guarantee, the provisions of this Statement are required to be applied retroactively. Disclosures related to cumulative amounts paid or received in relation to a nonexchange financial guarantee may be applied prospectively.

How the Changes in This Statement Will Improve Financial Reporting

The requirements of this Statement will enhance comparability of financial statements among governments by requiring consistent reporting by those governments that extend nonexchange financial guarantees and by those governments that receive nonexchange financial guarantees. This Statement also will enhance the information disclosed about a government's obligations and risk exposure from extending nonexchange financial guarantees. This Statement also will augment the ability of financial statement users to assess the probability that governments will repay obligation holders by requiring disclosures about obligations that are issued with this type of financial guarantee.

> Unless otherwise specified, pronouncements of the GASB apply to financial reports of all state and local governmental entities, including general purpose governments; public benefit corporations and authorities; public employee retirement systems; and public utilities, hospitals and other healthcare providers, and colleges and universities. Paragraph 4 discusses the applicability of this Statement.

CONTENTS

INTRODUCTION

1. When a government extends a financial guarantee, it has agreed to indemnify a third party if the entity or individual that issued the guaranteed obligation does not fulfill its requirements under the obligation. Some governments guarantee financial obligations of other governments, nongovernmental entities, or individuals without receiving equal or approximately equal value in return—a nonexchange transaction. Generally, these types of guarantees are extended by governments as part of their mission to assist other governments, nongovernmental entities, or individuals within the government's jurisdiction.

2. Similarly, a government may receive a financial guarantee for an obligation it has issued without providing equal or approximately equal value in return. For example, a school district may receive a financial guarantee from a state government for the district's debt service payments on construction bonds it has issued without providing considera-

tion to the state government.

3. The objective of this Statement is to improve the recognition, measurement, and disclosure guidance for state and local governments that have extended or received financial guarantees that are nonexchange transactions.

STANDARDS OF GOVERNMENTAL ACCOUNTING AND FINANCIAL REPORTING

Scope and Applicability of This Statement

4. This Statement establishes accounting and financial reporting standards for financial guarantees that are nonexchange transactions[1] (nonexchange financial guarantees) extended or received by a state or local government. As used in this Statement, a nonexchange financial guarantee is a guarantee of an obligation of a legally separate entity or individual, including a blended or discretely presented component unit, which requires the guarantor to indemnify a third-party obligation holder under specified conditions. The provisions of this Statement should be applied to financial statements of all state and local governments.

5. This Statement does not apply to guarantees related to special assessment debt within the scope of Statement No. 6, *Accounting and Financial Reporting for Special Assessments*.

6. This Statement amends NCGA Statement No. 4, *Accounting and Financial Reporting Principles for Claims and Judgments and Compensated Absences*, paragraph 9; GASB Statement No. 10, *Accounting and Financial Reporting for Risk Financing and Related Insurance Issues*, paragraph 3; GASB Statement No. 33, *Accounting and Financial Reporting for Nonexchange Transactions*, paragraph 5; and GASB Statement No. 62, *Codification of Accounting and Financial Reporting Guidance Contained in Pre-November 30, 1989 FASB and AICPA Pronouncements*, paragraphs 98, 109, 110, and 124.

Recognition and Measurement of Nonexchange Financial Guarantees

Governments Extending Nonexchange Financial Guarantees

7. A government that has extended a nonexchange financial guarantee should consider qualitative factors in assessing the likelihood that the government will be required to make a payment in relation to the guarantee. Examples of such qualitative factors relevant to the entity or individual that has issued the guaranteed obligation include, but are not limited to, the following:

a. Initiation of the process of entering into bankruptcy or financial reorganization
b. Breach of a debt contract in relation to the guaranteed obligation, such as failure to meet rate covenants, failure to meet coverage ratios, or default or delinquency in interest or principal payments
c. Indicators of significant financial difficulty, such as failure to make payments to paying agents or trustees on a timely basis; drawing on a reserve fund to make debt service payments; initiation of a process to intercept receipts to make debt service payments; debt holder concessions; significant investment losses; loss of a major revenue source; significant increase in noncapital disbursements in relation to operating or current revenues; or commencement of financial supervision by another government.

8. Some governments extend similar nonexchange financial guarantees to more than one entity or individual. For example, a state government may guarantee debt issued by qualifying school districts within the state for construction of capital assets. If a government extends similar guarantees to a group, the government should consider applicable qualitative factors and relevant historical data, if any, in assessing the likelihood that the government will make a payment in relation to those guarantees. For example, a government that has historical data on the default frequency of a group of guarantees should consider those data in relation to its outstanding guarantees in assessing the likelihood that it will be required to make a payment on one or more of the guarantees within the group.

Recognition and Measurement in Financial Statements Prepared Using the Economic Resources Measurement Focus

9. When qualitative factors and historical data, if any, as discussed in paragraphs 7 and 8, indicate that it is more likely than not[2] that a government will be required to make a payment related to the nonexchange financial guarantees it extended for liabilities of other entities or individuals, the government should recognize a liability and an expense in financial statements prepared using the economic resources measurement focus. The amount recognized should be the discounted present value of the best estimate of the future outflows expected to be incurred as a result of the guarantee. If there is no best estimate of the future outflows expected to be incurred but a range of estimated future outflows can be established in which no amount within that range appears to be a better estimate than any other amount, the discounted present value of the minimum amount in that range should be recognized. Classification of expenses related to nonexchange financial guarantees should be determined in the same manner as grants or financial assistance payments to other entities or individuals.

Recognition and Measurement in Financial Statements Prepared Using the Current Financial Resources Measurement Focus

10. When qualitative factors and historical data, if any, as discussed in paragraphs 7 and 8, indicate that it is more likely than not that a government will be required to make a payment related to the nonexchange financial guarantees it extended for liabilities of other entities or individuals, the government should recognize a fund liability and an expenditure in financial statements prepared using the current financial resources measurement focus, to the extent the liability is normally expected to be liquidated with expendable available financial resources. Liabilities for nonexchange financial guarantees extended are normally expected to be liquidated with expendable available financial resources when payments are due and payable on the guaranteed obligation. Classification of expenditures related to nonexchange financial guarantees should be determined in the same manner as grants or financial assistance payments to other entities or individuals.

Governments Issuing ■ Guaranteed Obligation

11. Under both the economic resources measurement focus and the current financial resources measurement focus, if a government is required to repay a guarantor for nonexchange financial guarantee payments made on the government's obligations, the government should reclassify that portion of its previously recognized liability for the guaranteed obligation as a liability to the guarantor. The government that issued the guaranteed obligation should continue to recognize its liability until that portion of the liability is legally released, such as when a Plan of Adjustment is confirmed by the court in the case of bankruptcy.

12. When a government that has issued an obligation that has received a nonexchange financial guarantee is legally released as an obligor from the obligation and from any liability to the guarantor, the government should recognize revenue to the extent of the reduction of its guaranteed liabilities.

Intra-Entity Nonexchange Financial Guarantees Involving Blended Component Units

13. When a government that extends a nonexchange financial guarantee recognizes a liability for the guarantee in accordance with paragraph 9 or 10, the government that issued the guaranteed obligation should recognize a receivable equal to the amount of the liability recognized by the government that extended the guarantee, only if the government that issued the guaranteed obligation is one of the following:

a. A blended component unit of that government
b. A primary government that includes the government that extended the guarantee as a blended component unit within its reporting entity
c. Within the same reporting entity and both parties are blended component units of the same primary government.

1. The scope of this Statement excludes both exchange and exchange-like transactions. The difference between exchange and exchange-like transactions is a matter of degree. In contrast to a "pure" exchange transaction, an exchange-like transaction is one in which the values exchanged, though related, may not be quite equal or in which the direct benefits may not be exclusively for the parties to the transaction. Nevertheless, the exchange characteristics of the transaction are strong enough to justify treating the transaction as an exchange for accounting recognition.

2. As used in this Statement, the term *more likely than not* means a likelihood of more than 50 percent.

Disclosures

Governments That Extend Nonexchange Financial Guarantees

14. A government that extends nonexchange financial guarantees should disclose the following information, by type of guarantee, for all nonexchange financial guarantees, regardless of the likelihood of a payment being required:

a. A description of the nonexchange financial guarantee, identifying:
   (1) The legal authority and limits for extending the guarantees and types of obligations guaranteed
   (2) The relationship of the government to the issuer or issuers of the obligations that are guaranteed
   (3) The length of time of the guarantees
   (4) Arrangements for recovering payments from the issuer or issuers of the obligations that are guaranteed

b. The total amount of all guarantees extended that are outstanding at the reporting date.

15. A government that recognizes a nonexchange financial guarantee liability or has made payments during the reporting period on nonexchange financial guarantees extended should disclose the following information:

a. A brief description of the timing of recognition and measurement of the liabilities and information about the changes in recognized guarantee liabilities, including the following:
   (1) Beginning-of-period balances
   (2) Increases, including initial recognition and adjustments increasing estimates
   (3) Guarantee payments made and adjustments decreasing estimates
   (4) End-of-period balances

b. Cumulative amounts of indemnification payments that have been made on guarantees extended that are outstanding at the reporting date

c. Amounts expected to be recovered from indemnification payments that have been made through the reporting date.

Governments That Issue Guaranteed Obligations

16. A government that has one or more outstanding obligations at the reporting date that have been guaranteed by another entity as part of a nonexchange transaction should disclose the following information about the guarantee(s) by type of guarantee:

a. The name of the entity providing the guarantee
b. The amount of the guarantee
c. The length of time of the guarantee
d. The amount paid, if any, by the entity extending the guarantee on obligations of the government during the current reporting period
e. The cumulative amount paid by the entity extending the guarantee on outstanding obligations of the government
f. A description of requirements to repay the entity extending the guarantee
g. The outstanding amounts, if any, required to be repaid to the entity providing the guarantee.

17. If a government has issued a guaranteed obligation for which payments have been made during the reporting period by the entity that extended the guarantee and that guaranteed obligation is no longer outstanding at the end of the reporting period, regardless of whether the government has any other outstanding guaranteed obligations at the end of the reporting period, it should disclose:

a. The amount paid by the entity that extended the guarantee on obligations of the government during the current reporting period
b. The cumulative amount paid by the entity that extended the guarantee on outstanding obligations of the government
c. A description of requirements to repay the entity that extended the guarantee
d. The outstanding amounts, if any, required to be repaid to the entity that provided the guarantee.

EFFECTIVE DATE AND TRANSITION

18. The requirements of this Statement are effective for financial statements for reporting periods beginning after June 15, 2013. Earlier application is encouraged. In the period this Statement is first applied, changes made to comply with this Statement should be treated as an adjustment of prior periods, and financial statements presented for the periods affected should be restated. If restatement of the financial statements for all prior periods presented is not practical, the cumulative effect of applying this Statement, if any, should be reported as a restatement of beginning net position (or fund balance or fund net position, as appropriate) for the earliest period restated (generally the current period). Also, the reason for not restating prior periods presented should be explained. In the period this Statement is first applied, the financial statements should disclose the nature of any restatement and its effect.

19. The requirements for disclosure of cumulative amounts in paragraphs 15, 16, and 17 may be applied prospectively. If applied prospectively, the disclosure should state the date through which the cumulative amounts are determined.

The provisions of this Statement need not be applied to immaterial items.

This Statement was issued by the affirmative vote of six members of the Governmental Accounting Standards Board. Ms. Taylor dissented.

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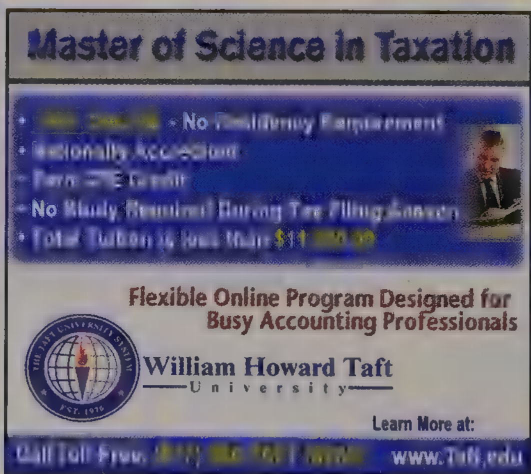

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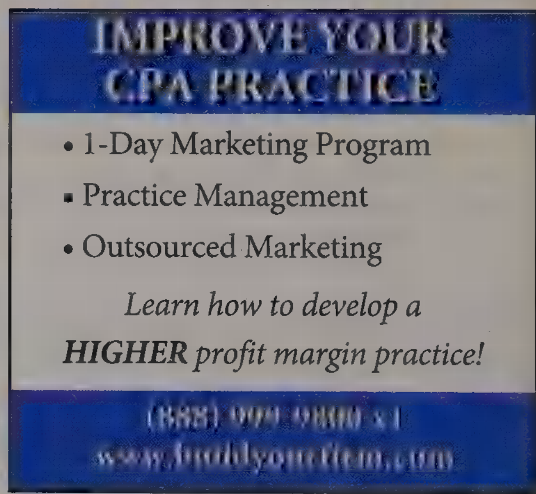

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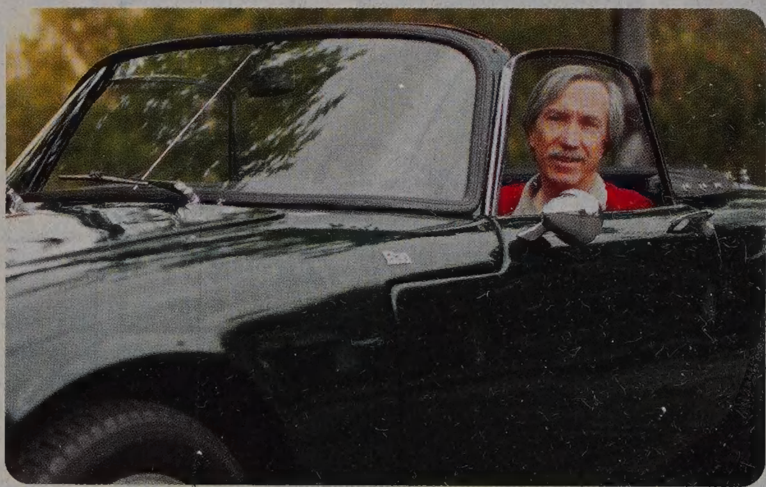
THE LAST WORD

I've served on many accounting boards and committees. The experience has been great. I've made so many friends, and I feel like I've made at least some difference in our profession as a consequence. In addition to teaching at Cal State, Long Beach, I teach accounting to judges, investment managers, and bankers. Part of my career has been explaining how to read financial statements—what people can learn from them and what they can't.

I served on the AICPA Accounting Standards Executive Committee (AcSEC) [now called the Financial Reporting Executive Committee]. We wrote accounting standards that were a part of GAAP. That was really cool. I was appointed to the committee in 1990. There's only one academic on the committee, so I was very pleased to be selected.

I've been teaching at Long Beach since 1989. I love it there, love the students. We have so many first-generation college students. My dad was a gardener, and nobody in my family had gone to college, so I love talking to these kids who come from similar backgrounds to mine. My dad was an immigrant from Canada.



John Lacey, CPA, Ph.D.
Professor, California State University, Long Beach
Long Beach, Calif.

I'm a minority owner of The Comedy & Magic Club. My brother, Mike, runs it and is the majority owner. Robin Williams helped design the club. One thing he suggested was having a green room, where comedians can hang out instead of having to sit at the bar with the patrons. It's kind of helped create this family atmosphere. The idea of camaraderie is encouraged.

My brother had the idea to open the club. He used to go to The Comedy Store in Los Angeles. He asked a friend to go, and the friend said, "It's too far to drive." He wanted something closer. About that time, there was a strike going on at The Comedy Store and The Improv because they weren't paying the comedians. My brother thought if the comedians were paid, maybe they'd make the 20-mile drive to Hermosa Beach. He talked to the comedians and they said, "Sure."

We sat down with a calculator and a piece of paper. I knocked out the numbers, and it looked like it would work. We asked questions. What could we charge as admission? What's the rent? How many can we seat? Can we get a liquor license? How much can we charge for a drink? Back then, we didn't have a kitchen. We just served beer and wine because that was what we could afford. We had Dave Letterman or Jay Leno playing to 30 people. The first couple of years it struggled, but then it really picked up. It's been in business almost 35 years, so it worked.

I've enjoyed getting to know the comedians. Jay Leno and I have been friends for 35 years. He's been wonderful to my family. I owned a Lamborghini Miura, which is a cool Italian sports car. When our first daughter was born, my wife said, "The car seat doesn't fit in this car," and I said, "So." I ended up selling it to Jay, and he started playing our comedy club more often to pay it off. He still has that car, and he still plays on Sunday nights and tries out material for *The Tonight Show* at our club.

I have an obsession with cars. I'm not sure how it started, but I've loved them since I was about 3 years old. I've owned many stupid cars. I have a Jaguar XK-E roadster, a BMW M5, a Lotus Elan roadster, and a Lotus Turbo Esprit.

When I was teaching at the University of Southern California, we had donor dinners. Accountants would speak after dinner, and people would be falling asleep in their dessert. About 25 years ago, I said to the dean, "Why don't you let me have a comedian come speak?" He said, "No, we need something professional." I said I would write a speech about accounting in the 21st century, and the comedian could read some of the speech and do some comedy. Then it would have a professional component. So the dean said, "OK." The comedian read some of the speech, told some jokes, and read some of the speech. The funny thing is some people never got it, that it was a comedian. The funnier thing is the comedian I got to do that was Jerry Seinfeld.

—As told to Neil Amato, namato@aicpa.org, a JofA senior editor.

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